

**NEW ISSUE - BOOK-ENTRY ONLY**

**RATINGS:**      **Moody's:**      **Aa2**  
                          **S&P:**      **AA-**  
                          **Fitch:**      **AA-**  
 (See "RATINGS" herein)

In the opinion of Bond Counsel to the Department as described herein, under existing statutes and court decisions, and assuming continuing compliance with certain tax covenants, (a) interest on the Offered Revenue Bonds is excluded from gross income for Federal income tax purposes pursuant to Section 103 of the Internal Revenue Code of 1986, as amended (the "Code"); and (b) interest on the Offered Revenue Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations. See "TAX MATTERS" herein.



**\$42,600,000**  
**Department of Veterans Affairs of the State of California**  
**Home Purchase Revenue Bonds**  
**2005 Series A (Non-AMT)**

**Date:** April 1, 2005

**Due:** As shown below

The 2005 Series A Bonds referred to above (the "Offered Revenue Bonds") will be issued as fully-registered bonds in initial denominations of \$5,000 or any integral multiples thereof in book-entry form. The Offered Revenue Bonds will mature in the years and bear interest at the rates set forth below:

**MATURITIES, PRINCIPAL AMOUNTS, INTEREST RATES AND CUSIPS**

<u>Maturity Date (December 1)</u>	<u>Principal Amount</u>	<u>Interest Rate</u>	<u>CUSIP</u>	<u>Maturity Date (December 1)</u>	<u>Principal Amount</u>	<u>Interest Rate</u>	<u>CUSIP</u>
2011	\$ 1,505,000	3.650%	130658JC2	2015	\$ 1,890,000	4.200 %	130658JG3
2012	1,600,000	3.800	130658JD0	2016	2,005,000	4.350	130658JH1
2013	1,690,000	3.900	130658JE8	2017	2,125,000	4.450	130658JJ7
2014	1,785,000	4.000	130658JF5	2018	2,250,000	4.500	130658JK4

\$20,215,000 4.75% 2005 Series A Term Bond due December 1, 2025, CUSIP No. 130658JL2

\$7,535,000 4.80% 2005 Series A Term Bond due December 1, 2027, CUSIP No. 130658JM0

Price of all Offered Revenue Bonds: 100%  
 (plus accrued interest)

Interest on the Offered Revenue Bonds is payable on June 1 and December 1 of each year, commencing December 1, 2005. The California State Treasurer's Office will serve as trustee.

**The Offered Revenue Bonds are subject to redemption prior to maturity, as described herein. See "THE OFFERED REVENUE BONDS - REDEMPTION."**

The Offered Revenue Bonds are special obligations of the Department payable solely from, and equally and ratably secured with other Revenue Bonds by a pledge of, (i) an undivided interest in the assets of the Veterans' Farm and Home Building Fund of 1943 (the "1943 Fund") (other than proceeds of Veterans G.O. Bonds, as defined herein, and amounts in any Rebate Account), (ii) the Bond Reserve Account and (iii) the Loan Loss Account. The undivided interest in the assets of the 1943 Fund is secondary and subordinate to any interest or right in the 1943 Fund of the people of the State of California and of the holders of general obligation bonds under any general obligation veterans bond act. **The Department has no taxing power. Neither the faith and credit nor the taxing power of the State of California or any political subdivision thereof is pledged to the payment of the principal of or the interest on the Offered Revenue Bonds.**

The Offered Revenue Bonds are offered when, as and if issued and delivered to the Underwriters, subject to the approval of legality by The Honorable Bill Lockyer, Attorney General of the State of California, and by Hawkins Delafield & Wood LLP, Bond Counsel to the Department. Certain legal matters will be passed on by Quateman & Zidell LLP, Disclosure Counsel to the State, and for the Underwriters by their counsel, Kutak Rock LLP. Gardner, Underwood & Bacon LLC has served as Pricing Advisor to the State in connection with the issuance of the Offered Revenue Bonds. It is expected that the Offered Revenue Bonds in book-entry form will be available for delivery at the offices of The Depository Trust Company on or about April 28, 2005.

**Honorable Philip Angelides**  
**Treasurer of the State of California**

**Bear, Stearns & Co. Inc.**

**Lehman Brothers**  
 April 12, 2005.

**Merrill Lynch & Co.**

No dealer, broker, salesman or other person has been authorized by the Department of Veterans Affairs or the Underwriters to give any information or to make any representations with respect to the Department of Veterans Affairs or its Offered Revenue Bonds other than those contained in this Official Statement and, if given or made, such other information or representations must not be relied upon as having been authorized by any of the foregoing. The information set forth herein has been obtained from sources which are believed to be current and reliable. Estimates and opinions are included and should not be interpreted as statements of fact. Summaries of documents do not purport to be complete statements of their provisions and such summaries are qualified by references to the entire contents of the summarized documents. The information and expressions of opinion herein are subject to change without notice, and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Department of Veterans Affairs since the date hereof.

This Official Statement is not to be construed as a contract with the purchasers of the Offered Revenue Bonds.

The information set forth herein has been furnished by the Department and other sources which are believed to be reliable, but is not guaranteed as to accuracy or completeness. The information and expressions of opinions herein are subject to change without notice and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Department since the date hereof.

**IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVERALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE OFFERED REVENUE BONDS AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.**

Copies of this Official Statement may be obtained from:

**HONORABLE PHILIP ANGELIDES**

Treasurer of the State of California

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Arnold Schwarzenegger, Governor

**DEPARTMENT OF VETERANS AFFAIRS**

Thomas Johnson Secretary	Roger L. Brautigan Undersecretary
Robert U. Glazier Deputy Secretary of Communications	Sheryl A. Schmidt Deputy Secretary for Women Veterans Affairs
John F. Jackson Acting Chief Counsel of Legal Affairs	John M. Hanretty Director of Operations
Debra Lehr Chief, Farm and Home Purchases Division	Weijian Ni Chief, Bond Finance Division

**VETERANS' DEBENTURE FINANCE COMMITTEE  
AND VETERANS FINANCE COMMITTEE OF 1943**

Arnold Schwarzenegger, Governor

Philip Angelides State Treasurer	Steve Westly State Controller
Thomas Campbell Director of Finance	Thomas Johnson Secretary of Veterans Affairs

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Leo P. Burke, Vice Chairman  
Vernon Chong  
Col. James C. Crump, Jr., USAF (Ret.)  
William D. Jackson

**CALIFORNIA STATE TREASURER'S OFFICE**

Philip Angelides, State Treasurer  
(as Trustee and as Agent for Sale)

**ATTORNEY GENERAL OF THE STATE OF CALIFORNIA**

Bill Lockyer, Attorney General

**BOND COUNSEL TO THE DEPARTMENT**

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**DISCLOSURE COUNSEL TO THE STATE**

Quateman & Zidell LLP

**QUANTITATIVE CONSULTANT**

cfX Incorporated

**PRICING ADVISOR**

Gardner, Underwood & Bacon LLC

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**OFFICIAL STATEMENT  
of  
DEPARTMENT OF VETERANS AFFAIRS  
OF THE STATE OF CALIFORNIA  
RELATING TO  
\$42,600,000  
HOME PURCHASE REVENUE BONDS  
2005 SERIES A**

**INTRODUCTION**

This Official Statement is being furnished to provide information in connection with the sale of the Department of Veterans Affairs of the State of California (the "Department") Home Purchase Revenue Bonds, 2005 Series A (the "Offered Revenue Bonds"), which will mature in the years and will bear interest at the rates set forth on the cover page hereof.

The Offered Revenue Bonds are being issued pursuant to (1) the Veterans' Revenue Debenture Act of 1970, as amended (the "Act"), constituting Chapter 7 of Division 4 of the Military and Veterans Code (the "Veterans Code") of the State of California (the "State"); (2) the Resolution of Issuance for Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, adopted March 19, 1980 (the "Original Resolution"); (3) the Eighth Supplemental Resolution Providing for Amendments and Supplements to the Resolution No. RB-1, adopted November 24, 1997, as amended (the "Eighth Supplemental Resolution"); and (4) the Tenth Supplemental Resolution Providing for Amendments and Supplements to Resolution No. RB-1, adopted February 24, 1999 (the "Tenth Supplemental Resolution"). The Offered Revenue Bonds are also being issued pursuant to a separate additional authorizing Series Resolution. The Original Resolution, as amended and supplemented by the Eighth Supplemental Resolution and the Tenth Supplemental Resolution, is referred to as "Resolution RB-1," and Resolution RB-1 and the Series Resolution authorizing the issuance of the Offered Revenue Bonds (the "Sixteenth Supplemental Resolution") are collectively referred to herein as the "Resolution." The State Treasurer is trustee for the Revenue Bonds (as defined below) pursuant to Resolution RB-1 (the "Trustee").

The Department has previously issued under Resolution RB-1 and separate Series Resolutions its 1997 Series A Bonds, 1997 Series B Bonds and 1997 Series C Bonds, its 1998 Series A Bonds, its 1999 Series A Bonds, its 1999 Series B Bonds, its 2000 Series A Bonds, its 2000 Series B Bonds, its 2000 Series C Bonds, its 2001 Series A Bonds, its 2002 Series A Bonds and its 2003 Series A Bonds (the "Prior Revenue Bonds"). The outstanding Prior Revenue Bonds, the Offered Revenue Bonds, and the bonds of any additional series issued under Resolution RB-1 ("Additional Revenue Bonds") are secured on a parity basis (except for bonds which are subordinate obligations as expressly provided in Resolution RB-1 or in a Series Resolution) and are collectively referred to herein as "Revenue Bonds."

The Department anticipates the contemporaneous issuance of \$221,475,000 State of California General Obligation Bonds Series CA and Series CB (the "2005 G.O. Bonds") which are expected to be used to reimburse the Department for existing Contracts of Purchase previously funded and to refund certain Veterans G.O. Bonds and/or State commercial paper.

The Offered Revenue Bonds and the 2005 G.O. Bonds are separate and independent bond issues, although they are treated as a single issue for certain Federal tax purposes. The Offered Revenue Bonds and the 2005 G.O. Bonds will each be offered and sold pursuant to a separate official statement, copies of which, when available, may be obtained from the Department (see “Additional Information”). The issuance of the Offered Revenue Bonds is not dependent upon the issuance of the 2005 G.O. Bonds.

Revenue Bonds, including the Offered Revenue Bonds, are special obligations of the Department payable solely from, and equally and ratably secured with other Revenue Bonds by a pledge of, (i) an undivided interest in the assets of the Veterans’ Farm and Home Building Fund of 1943 (the “1943 Fund”) other than proceeds of Veterans G.O. Bonds (defined below) and any amounts in any Rebate Account, (ii) the Bond Reserve Account and (iii) the Loan Loss Account. The undivided interest in the assets of the 1943 Fund is secondary and subordinate to any interest or right in the 1943 Fund of the people of the State and of the holders of general obligation bonds issued by the Department under any and all present and future veterans general obligation bond acts (collectively, the “Veterans G.O. Bonds”). See “SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS.” **The Department has no taxing power. Neither the faith and credit nor the taxing power of the State or any political subdivision thereof is pledged to the payment of the principal of or the interest on the Offered Revenue Bonds.**

Under the Department’s Farm and Home Purchase Program (the “Program”), the Department acquires residential property to be sold to eligible veterans under contracts of purchase between the Department and such veterans (“Contracts of Purchase”). Such acquisitions are financed principally with the proceeds of bonds, including Veterans G.O. Bonds and Revenue Bonds.

See “PLAN OF FINANCE” for a discussion of the uses of the proceeds of the Offered Revenue Bonds.

All capitalized terms used in this Official Statement and not defined herein shall have the meanings set forth in the Resolution. See “SUMMARY OF CERTAIN PROVISIONS OF THE RESOLUTION – Definitions (Section 103)” and “THE OFFERED REVENUE BONDS – Certain Definitions from the Sixteenth Supplemental Resolution.”

## **PLAN OF FINANCE**

### **General**

The Offered Revenue Bonds are being issued for the purpose of refunding certain Outstanding Revenue Bonds (the “Refunded Bonds”) and to reduce the Department’s cost of borrowing and/or to replace certain outstanding variable rate Revenue Bonds with fixed rate Revenue Bonds. See “ESTIMATED APPLICATION OF OFFERED REVENUE BOND PROCEEDS.” See “SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS – General,” “– The 1943 Fund” and “– Cash Flow Statements and Program Operating Procedures.” Also see APPENDIX C – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Veterans G.O. Bonds and Revenue Bonds – Selected Information with Respect to Veterans G.O. Bonds and Revenue Bonds” for information

about Revenue Bonds and Veterans G.O. Bonds, including Veterans G.O. Bonds expected to be refunded with proceeds of the Offered Revenue Bonds.

## **THE DEPARTMENT**

### **General**

In 1921, the California Legislature created the Veterans' Welfare Board and the Program. The Department of Veterans Affairs became the successor to the Veterans' Welfare Board under the Farm and Home Purchase Act of 1943. The Department is a subdivision of the State and constitutes a public corporation. One of the Department's basic objectives is to provide eligible veterans the opportunity to acquire homes with long-term low-interest financing provided under the Program.

The California Veterans Board ("Board") determines the policies for all operations of the Department. The Board is composed of seven members appointed by the Governor, subject to Senate confirmation, for respective terms of four years except that the member of the Board who is a resident of a California veterans home shall have a two year term. All of the members of the Board must be veterans, one member must be retired from the active or reserve forces of the United States military service, one member must have substantial training or professional expertise in mortgage lending and real estate finance, one member must have substantial training or professional expertise in geriatrics, gerontology, or long-term care, and one member must be a resident of one of the California veterans homes run by the Department established for qualified aged and disabled veterans and their spouses. There are presently two vacancies on the Board.

There are four principal divisions within the Department: the Division of Veterans Services, the Division of Administration, the Veterans' Home Division and the Division of Farm and Home Purchases. The Program is administered by the Division of Farm and Home Purchases with support from the Division of Administration and other Department support units. See "THE PROGRAM."

### **Administration**

In addition to its headquarters in Sacramento, the Division of Farm and Home Purchases maintains field offices located throughout the State. These local offices, in addition to providing information to all veterans concerning the Program, are responsible for Contract of Purchase originations and the initial collection and evaluation of data regarding applicants for the Program and the properties to be acquired under the Program. This includes examinations as to the qualification of veterans to participate in the Program, a credit analysis for each applicant, ordering appraisals of properties and the initial processing of the veterans' applications for Contracts of Purchase. Field offices handle the complete loan processing for construction loans and also handle overflow from the Sacramento headquarters when volume is high.

Final processing and servicing of the Contracts of Purchase are performed by the Department at its headquarters and entail Contract of Purchase accounting, insurance and property damage claims adjustment and services, Contract of Purchase alterations and contract performance services. The Department allows certain specially-trained and certified mortgage

brokers to originate Contracts of Purchase. All Contracts of Purchase are serviced by the Department. The Department uses an integrated loan processing and financial information system ("Mitas") for origination and servicing of all Contracts of Purchase. General administration of the Program, including fiscal, legal, personnel and other administrative functions, is also performed at the Department's headquarters. As of February 28, 2005, the Department had a staff of approximately 155 persons in support of the Program.

The Secretary and other staff personnel of the Department principally responsible for the administration of the Program are listed below. The Secretary is appointed by the Governor of the State, serves at the pleasure of the Governor and must be a veteran.

*Thomas Johnson, FACHE*  
*Secretary since February 2004*

A Vietnam Era Veteran with more than 34 years in healthcare management experience, Mr. Johnson is a graduate of the University of Minnesota and holds a Masters Degree in public health from the University of California, Los Angeles. His knowledge of healthcare finance and management began with his service in the Medical Service Corps branch of the United States Army. He managed a 600-bed hospital and acted as commanding officer for Army patients dislocated from their units in Vietnam. Upon his return from overseas deployment and discharge from the Army, Mr. Johnson served for 31 years as a hospital administrator in Tulare County, first at Tulare District Hospital and later at Kaweah Delta District Hospital in Visalia. Since 2001, Mr. Johnson has served as a consultant to The California Endowment and to several health care organizations. Mr. Johnson is a Life Fellow with the American College of Healthcare Executives and is the board chair of the California Institute for Nursing and Healthcare. An active member in his community, Mr. Johnson has been involved with a great variety of local, state and federal groups.

*Roger L. Brautigan*  
*Undersecretary since June 2004*

Mr. Brautigan is a 33-year veteran of the U.S. Army, achieving the rank of Major General while serving in a variety of active and reserve command and staff positions in the United States, Vietnam and Germany. His command assignments ranged from Platoon leader to both company and battalion level commands. Most recently he served as deputy commanding general and chief of staff, I Corps and Fort Lewis in Fort Lewis, WA. Mr. Brautigan holds a Bachelor of Science degree from the University of Arizona at Tucson and a Master's degree from the University of the Pacific at Stockton, California. He is a graduate of the Armor, Infantry, and Adjutant General Officer Advanced Courses, Army Command and General Staff College, and the Army War College. Mr. Brautigan's military awards and decorations include the Defense Distinguished Service Medal, the Distinguished Service Medal, the Legion of Merit (with oak leaf cluster), the Bronze Star Medal, the Defense Meritorious Service Medal, the Meritorious Service Medal (with 3 oak leaf clusters), the Army Commendation Medal (with 3 oak leaf clusters), the Army Achievement Medal (with oak leaf cluster), various service and unit awards, and the Army General Staff Identification Badge.

*Robert Udall Glazier*  
*Deputy Secretary since March 2004*

Mr. Glazier has 20 years of experience in corporate and political communications, with an emphasis on public policy. He was appointed as Deputy Secretary of Veterans Affairs by Governor Schwarzenegger in March of 2004. Mr. Glazier received his Bachelor of Arts degree in political science from Brigham Young University and his Juris Doctorate Degree from South Texas College of Law, where he was on the Dean's List and received the American Jurisprudence Award for Constitutional Law. He is an attorney licensed in both Texas and Utah.

*Sheryl A. Schmidt*  
*Deputy Secretary since November 1996*

After leaving the accounting firm of Touche Ross (now known as Deloitte & Touche LLP) in 1987, Deputy Secretary Schmidt began her state career at the State Controller's Office as a Certified Public Accountant (CPA). In 1995, she accepted the newly created position of Chief of Audits at the Department and developed the Internal Audit Division. In 1996, the Governor of California appointed United States Air Force veteran Sheryl Schmidt as the Deputy Secretary of Women Veterans Affairs. Ms. Schmidt holds a Bachelor's degree in management from St. Leo's College in Florida, a Master's of Business Administration (MBA) from California State University, Sacramento, and a CPA license from the California State Board of Accountancy.

*John Hanretty*  
*Director of Operations since August 2004*

Mr. Hanretty is a United States Air Force, Vietnam-era veteran who graduated from California State University, Sacramento in 1975 with a degree in Government. After graduation, he worked for eight years in the California Department of Health Services regulating Prepaid Health Plans for Medicaid clients. He then spent twelve years in management positions with private health maintenance organizations in Arizona and California rising to the level of Chief Executive Officer. His responsibilities included sales, medical management, provider staffing, member services, contracting, financial accounting and budgeting. He returned to State government service in 1994 as a Budget Manager. Mr. Hanretty served as the Budget Officer for the Department from August 1998 until September 1999, was Chief, Administrative Services Division from September 1999 until July 2004, and was appointed Director of Operations in August 2004. He has continuously served on community non-profit boards of directors during his professional career.

*John F. Jackson*  
*Acting Chief Counsel of Legal Affairs since March 2005*

John F. Jackson received a Bachelor of Arts degree from Baylor University in 1955 with a double major in English and History. Following his graduation from Baylor, he entered the United States Navy and served as an Airborne CIC Officer. During his tour in the Navy, he was able to attend the University of San Francisco where he obtained a J. D. degree in 1963. In 1965, after working two years for Travelers Insurance Company as a supervising adjuster, Mr. Jackson

opened a law office in Sunnyvale, California where he practiced for the next 35 years. He was president of the Sunnyvale, Cupertino Bar Association and an arbitrator for the American Bar Association and the Superior Court of the County of Santa Clara. During this time, he also taught Civil Procedure, Torts and Constitutional Law at De Anza College in Cupertino, California, in the Administration of Justice/Para-Legal Program for over 12 years and was selected by his students to Who's Who Among American Teachers. Mr. Jackson has been with the Department since January 2001.

*Debra Lehr*

*Chief, Farm and Home Purchases Division since July 2003*

Ms. Lehr brings more than 30 years of Cal-Vet program experience to the position of Division Chief. Her responsibilities have included loan origination, appraisal, underwriting, legal, marketing, collections and foreclosure functions. Since 1995, she has held the positions of Foreclosure/REO Unit Manager, Loan Servicing Operations Manager, and Assistant Division Chief with oversight of all loan-servicing functions, and was responsible for the successful centralization and reengineering of the program's delinquent account, foreclosure and REO processes. Ms. Lehr was appointed Division Chief July 2003.

*Weijian Ni*

*Chief, Bond Finance Division since March 2004*

Mr. Ni brings to his current position more than 10 years of service of financial analysis and management in the California State government. Since joining the Department in 1996, Mr. Ni has held various analyst and management positions in Bond Finance and Accounting. Mr. Ni holds a Master's degree in Business Administration (MBA) from California State University, Sacramento.

## **External Review of the Program**

The Program and the Department have been the subject of several external reviews by the executive and legislative branches of State government. A summary of certain of these reviews is presented below.

### *The Legislative Analyst's Office of the State of California*

The Legislative Analyst's Office of the State of California (the "LAO"), issued a report in 1998 entitled "Rethinking the Cal-Vet Loan Program" (the "1998 Report"), and an analysis of the then-proposed Governor's Budget 1999/2000, which analysis included a discussion of the Department (the "1999 Report" and, together with the 1998 Report, the "1998/99 LAO Reports.") The stated purpose of the LAO is to provide analysis and nonpartisan advice to the California Legislature on fiscal and policy issues. The LAO is overseen by the Joint Legislative Budget Committee, a 14-member bipartisan committee composed of an equal number of State Assembly and State Senate members.

In the 1998/99 LAO Reports, the LAO analyzed the historical and financial performance and lending activities of the Department and made various recommendations. The 1998/99 LAO Reports described the financial losses experienced by the Department, the increasing rate of repayment of Contracts of Purchase, and the decreased lending activity in recent years. The 1998/99 LAO Reports were issued before the impact of the Department's 1997/98 programmatic changes had been realized.

On February 17, 2000, the LAO issued an analysis of the proposed Governor's Budget for Fiscal Year 2000-01, which analysis included a discussion of the Department. The report recognized that the administrative costs of the Program are not part of the State budget, but recommended that the Department report to the State Legislature during budget hearings on the reasons for certain cost increases and the steps it is taking to reduce such costs. The LAO did not address the Program, Veterans G.O. Bonds, Revenue Bonds, or the 1943 Fund (defined below) in its reports on the Governor's Budget for Fiscal Year 2001-2002 or thereafter.

#### *Bureau of State Audits*

On May 25, 2000, the Bureau of State Audits ("BSA") released an audit report concluding that the loan program will substantially lose its ability to offer low-cost home loans to veterans beyond the next decade due to the restrictive eligibility requirements attributed to certain program funding and the limited availability of other funding sources. The BSA further concluded that the Department was eroding loan program funds due to insufficient budget controls, inefficient and inconsistent loan operations and by charges to the loan program for unrelated administrative positions and costs. Finally, the BSA concluded, based in part upon its conclusion that the Department's testing of its integrated information system was incomplete, that the Department will need to spend more time and money to ensure that its integrated information system provides necessary, reliable program and financial information. The Department disagreed with certain conclusions of the BSA and expressed the belief that it had already addressed certain report findings.

On March 28, 2001, the BSA released an audit report prepared in response to the Legislature's direction for an audit of the Department's life and disability insurance program. The programs that were examined by the audit report are no longer in place. See "THE PROGRAM – Property and Life and Disability Insurance" and APPENDIX C – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA."

Copies of the 1998/99 LAO Reports and the May 25, 2000 and March 28, 2001 reports of the BSA, including the Department's responses thereto, are available from the Department upon request.

In June 2003 the BSA released its report pertaining to the Board and to the Department's responses to recommendations in prior audits. The audit concludes among other things that (i) the Board has not established itself as an effective policy-maker for the Department; (ii) the Board lacks independent counsel to minimize the legal risks of its policy-making and appeals actions; (iii) the Board's appeal process needs improvement to ensure that veterans' appeals are handled consistently and appropriately; (iv) the Board's effectiveness is hindered by its reduced membership and lack of training on its responsibilities; and (v) although the Department has

implemented eight of the fourteen recommendations that were reviewed from previous BSA audits, it has not given sufficient attention to the projected decrease in the number of veterans who will be eligible for QVMB-backed loans which could affect the long-term viability of the Program.

In written responses to the June 2003 audit, the Board and the Department responded to all of the audit's conclusions. With respect to the point made in (i) above, the Board stated that it will develop action plans based on recommendations provided in the June 2003 audit and will seek outside legal counsel to assist in formulating policies for the Board. The Board adopted a policy in December, 2004 which permits the hiring of a retired attorney to provide assistance to the Board in the development of policies and other matters. The Board is currently in the process of hiring such Special Counsel. With respect to the points made in (ii) and (iii) above the Board stated in its response that it will create a manual and include procedures for conducting all levels of appeals and it will establish a policy for having independent counsel and will provide funding accordingly. The Board has adopted an appeals procedure and is currently working on a pamphlet for appellants to explain the appeals process. As mentioned above, the Board is in the process of hiring a Special Counsel. With respect to the point made in (iv) above the Board stated that it will appoint a training coordinator and develop a formalized training plan for the Board. The Board adopted a formal orientation program for new Board members which includes training by a Department training coordinator, an overview of Board Member duties and responsibilities and provision of copies of the Military and Veterans Code and the Bagley-Keene Act. With respect to the point made in (v) above, the Department stated that it is addressing this issue through its efforts to effect passage of federal legislation and it is continuing to monitor funding pools to determine if and when an alternative funding source may be necessary. In particular, the Department explained that in order to provide a home loan benefit to the greatest number of qualifying veterans, the Department has been engaged in efforts to change federal tax laws governing QVMB-backed loans. Although the audit pointed out that similar efforts made in 1997 and 1999 were unsuccessful, the Department believes that since the September 11, 2001 tragedy and the recent war in Iraq, the political climate is positive for the passage of bills regarding veterans' issues and that a bill to change the federal tax law introduced in the United States Senate would find sufficient support to become law. In 2005, the Department, along with agencies offering similar programs in five other states, has worked on a new bill to change federal tax laws governing QVMB-backed loans that may be introduced this year. There can be no assurance that any such bill, if introduced, would become law.

## **SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS**

### **General**

The Revenue Bonds are special obligations of the Department payable solely from, and equally and ratably secured with other Revenue Bonds by a pledge of, (i) an undivided interest in the assets of the 1943 Fund other than (x) proceeds of Veterans G.O. Bonds and any (y) amounts in any Rebate Account, (ii) the Bond Reserve Account and (iii) the Loan Loss Account. **State law provides that such undivided interest in the assets of the 1943 Fund is secondary and**



**subordinate to the obligation of the 1943 Fund to pay or reimburse debt service on the Veterans G.O. Bonds, as described below. The Department has no taxing power. Neither the faith and credit nor the taxing power of the State of California or any political subdivision thereof is pledged to the payment of the principal of or the interest on the Revenue Bonds.**

### **The 1943 Fund**

The components of the 1943 Fund are (i) proceeds derived from the sale of Revenue Bonds, (ii) proceeds from the sale of Veterans G.O. Bonds, (iii) amounts receivable under all Contracts of Purchase and from sales of properties subject to cancelled Contracts of Purchase, (iv) temporary investments, cash and funds and (v) certain other miscellaneous assets. Proceeds of Veterans G.O. Bonds may not be applied to payment of principal of, and interest or any redemption premium on, the Revenue Bonds. The holders of Revenue Bonds are not entitled to compel the sale of Contracts of Purchase and the properties to which they relate, but are entitled to receive payment out of the Revenues derived from those Contracts of Purchase and properties, subject to the prior claims, if any, of the Veterans G.O. Bonds and of the State for reimbursement of debt service payments made on Veterans G.O. Bonds.

In addition to financing Contracts of Purchase and paying or reimbursing debt service on the Veterans G.O. Bonds and Revenue Bonds, as described below, moneys in the 1943 Fund are used to pay administrative costs of the Department, and to fund certain losses from and reserves for property insurance and life and disability insurance described in "THE PROGRAM – Property and Life and Disability Insurance."

For financial information concerning the 1943 Fund, see "SELECTED FINANCIAL DATA OF THE 1943 FUND AND DEPARTMENT'S DISCUSSION" and also see APPENDIX A – "FINANCIAL STATEMENTS OF THE 1943 FUND FOR FISCAL YEARS 2004 AND 2003 AND INDEPENDENT AUDITOR'S REPORT."

The Act and the Veterans Code provide that the undivided interest created by Resolution RB-1 in favor of the holders of Revenue Bonds in the assets of the 1943 Fund is secondary and subordinate to the interest of the people of the State and the holders of Veterans G.O. Bonds. The 2000 Bond Act provides that on the dates when funds in the General Fund are remitted to bondowners for the payment of debt service on Veterans G.O. Bonds issued under the 2000 Bond Act, moneys shall be returned to the General Fund from the 1943 Fund in an amount equal to such debt service payment (to the extent sufficient moneys are available in the 1943 Fund.) Moneys in the 1943 Fund must be paid, on the debt service payment dates of Veterans G.O. Bonds (other than those issued under the Veterans Bond Act of 2000), to the General Fund in the amount of the principal of (whether at maturity or upon redemption or acceleration), and premium and interest on such Veterans G.O. Bonds then due and payable (other than debt service payable from the proceeds of refunding bonds). Debt service on Veterans G.O. Bonds is payable from the General Fund, even if the amount transferred from the 1943 Fund to the General Fund is less than such debt service amount. The balance remaining unpaid to the General Fund from the 1943 Fund must be transferred to the General Fund out of the 1943 Fund as soon thereafter as it becomes available, together with interest thereon at the rate borne by the applicable Veterans G.O. Bonds, compounded semiannually. Until such

amounts are repaid to the General Fund, no payments may be made on the Revenue Bonds other than from amounts then in the Bond Reserve Account and the Loan Loss Account. These rights with respect to the 1943 Fund do not grant any lien on the 1943 Fund or the moneys therein to the holders of any Veterans G.O. Bonds.

As of December 31, 2004, there were outstanding \$1,270,685,000 aggregate principal amount of Veterans G.O. Bonds. Currently, \$605,585,000 of new issue Veterans G.O. Bonds are authorized but not issued (not including the 2005 G.O. Bonds). As of December 31, 2004, there were outstanding \$575,845,000 aggregate principal amount of Revenue Bonds outstanding, not including the Offered Revenue Bonds. Under the Act, Revenue Bonds in an aggregate principal amount not to exceed \$1,500,000,000, at any given time, may be outstanding. The Legislature may increase the amount of Revenue Bonds issuable under the Act or may decrease such amount to an amount not less than the amount of Revenue Bonds then outstanding. Additional information about outstanding Veterans G.O. Bonds and Revenue Bonds is in APPENDIX C – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Veterans G.O. Bonds and Revenue Bonds.”

For additional information regarding the existing interest rates of, and setting interest rates on, Contracts of Purchase, see “THE PROGRAM – Contracts of Purchase” and APPENDIX C – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase.”

### **Bond Reserve Account**

Resolution RB-1 requires the establishment and, from available Revenues, maintenance of a Bond Reserve Account in an amount at least equal to the Bond Reserve Requirement. Resolution RB-1 creates a lien in favor of the holders of the Revenue Bonds on amounts in the Bond Reserve Account which are not in excess of the Bond Reserve Requirement (as defined below). Resolution RB-1 establishes the Bond Reserve Requirement as of any date of calculation to be an amount equal to the aggregate of the amounts established by each Series Resolution authorizing Revenue Bonds, at least equal in the aggregate to 3% of the aggregate Outstanding principal amount of the Revenue Bonds with interest rates fixed to maturity (the “Bond Reserve Requirement”). For purposes of calculating the Bond Reserve Requirement, the Resolution established (1) with respect to the Prior Revenue Bonds, amounts of 3% to 7% of the Outstanding principal amount of the Prior Revenue Bonds; and (2) with respect to the Offered Revenue Bonds, an amount equal to 3% of the Outstanding principal amount of the Offered Revenue Bonds. Amounts in the Bond Reserve Account shall be used solely for the purposes of paying the principal of and interest on the Revenue Bonds or making Mandatory Sinking Account Payments (but only in the event that no other moneys other than certain moneys in the Revenue Bond Series Proceeds Subaccounts or Revenue Bond Series Proceeds Recycling Subaccounts are available therefor). Resolution RB-1 directs that amounts on deposit in the Bond Reserve Account as of any date in excess of the Bond Reserve Requirement be transferred at the request of the Department to the Loan Loss Account, the Revenue Account or the Proceeds Account.

As of December 31, 2004, the Bond Reserve Requirement was \$32,979,750 and the amount on deposit in the Bond Reserve Account was at least equal to the Bond Reserve

Requirement. Following the issuance of the Offered Revenue Bonds, no additional funds will need to be deposited into the Bond Reserve Account to meet the Bond Reserve Requirement.

Although the Department used cash to fund the Bond Reserve Requirement with respect to Prior Revenue Bonds (and expects to use cash to fund the Bond Reserve Requirement with respect to the Offered Revenue Bonds), the Series Resolutions authorizing the issuance of the Prior Revenue Bonds (including the Offered Revenue Bonds) provide that Cash Equivalents may replace such cash in the future. Resolution RB-1 permits Series Resolutions authorizing Additional Revenue Bonds to provide that Cash Equivalents be used to fund the Bond Reserve Requirement with respect to the Series of Bonds so authorized.

APPENDIX B includes audited financial statements of the Bond Reserve Account.

### **Loan Loss Account**

There are currently no amounts on deposit or required to be on deposit in the Loan Loss Account. No deposits will be required in connection with the issuance of the Offered Revenue Bonds.

Resolution RB-1 requires that the amount on deposit in the Loan Loss Account must be at least equal to the Loan Loss Requirement before any Additional Revenue Bonds may be issued. Resolution RB-1 establishes the Loan Loss Requirement, as of any date of calculation, as an amount equal to the amount established in the then-current Cash Flow Statement, as described below under “Cash Flow Statements and Program Operating Procedures.” The Cash Flow Statement which will be in effect upon the issuance of the Offered Revenue Bonds will not establish a Loan Loss Requirement. Resolution RB-1 provides that, pursuant to the Program Operating Procedures, moneys held for the credit of the Loan Loss Account as of any date at the request of the Department will be transferred to the Revenue Account, the Bond Reserve Account, the Proceeds Account or any Revenue Subaccount established with respect to the Veterans G.O. Bonds. Amounts in the Loan Loss Account will be used to pay the principal of and interest on the Revenue Bonds or to make Mandatory Sinking Account Payments.

Resolution RB-1 permits Series Resolutions authorizing Additional Revenue Bonds to provide that Cash Equivalents be used to fund the Loan Loss Requirement with respect to the Series of Bonds so authorized.

### **Cash Flow Statements and Program Operating Procedures**

Resolution RB-1 requires that the Department file a Cash Flow Statement with the Trustee (i) upon adoption of a Series Resolution authorizing Additional Revenue Bonds or amending Resolution RB-1 or any Series Resolutions or Supplemental Resolution, (ii) upon the issuance of any series of Veterans G.O. Bonds, (iii) when required pursuant to any Series Resolution or Supplemental Resolution, (iv) upon any change in the Program Operating Procedures described below and (v) in connection with compliance with the requirements described below under “SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS – Maintenance of Fund Parity.” Resolution RB-1 permits the Department to file a new Cash Flow Statement at any time. Resolution RB-1 requires that any Cash Flow

Statement be the subject of a Rating Confirmation if it does not include all the scenarios included in the Cash Flow Statement previously on file with the Trustee.

Resolution RB-1 requires that a Cash Flow Statement consist of a Certificate of the Department containing the conclusion of an Authorized Representative of the Department that projected Revenues will be sufficient to provide for timely payments of interest and principal on the Revenue Bonds and Expenses, under each of the scenarios included in the cash flow projections attached thereto. Under Resolution RB-1, "Revenues" means all moneys received by or on behalf of the Department representing (i) principal and interest payments on the Contracts of Purchase including all prepayments representing the same and all prepayment premiums or penalties received by or on behalf of the Department in respect of the Contracts of Purchase, (ii) interest earnings received on the investment of amounts to the extent deposited in the Revenue Account under Resolution RB-1, (iii) amounts transferred to the Revenue Account from the Bond Reserve Account or the Loan Loss Account and (iv) any other amounts payable by parties executing Contracts of Purchase or private participants in the Program or related to recoveries on defaulted Contracts of Purchase, including origination and commitment fees, servicing acquisition fees, and Liquidation/Insurance Proceeds, except to the extent not included as "Revenues" pursuant to the provisions of any Series Resolution.

Resolution RB-1 requires that a Cash Flow Statement will (i) take into account the financial position of the 1943 Fund, the Bond Reserve Account, and the Loan Loss Account as of the stated starting date of the projection, (ii) reflect all the significant transactions that have occurred in the period commencing with such starting date and ending with a date no more than ninety (90) days prior to the date of such projections, (iii) be consistent with Resolution RB-1 and (iv) assume compliance with the then-current Program Operating Procedures. For each scenario included therein, Resolution RB-1 requires that the Cash Flow Statement set forth the assumptions on which it is based including, without limitation, the following:

- (i) the timing and terms of issuance or remarketing of Revenue Bonds and Veterans G.O. Bonds;
- (ii) the timing of the acquisition of Contracts of Purchase and the interest rates thereon and maturities thereof;
- (iii) the timing and amounts of the receipt of payments of scheduled principal of and interest on Contracts of Purchase;
- (iv) the timing and amounts of prepayments on Contracts of Purchase;
- (v) the timing and amount of defaults on Contracts of Purchase and disposition or recovery prices of defaulted Contracts of Purchase, which assumption may be based on a specified model of default frequency and loss severity as a function of Contract of Purchase portfolio characteristics;
- (vi) the investment return on Accounts and subaccounts, to the extent that amounts on deposit will be subject to an investment agreement;

(vii) the performance by the Department's counterparty with respect to obligations under an enhancement agreement or arrangement for Supplemental Contract of Purchase Coverage or investment of funds;

(viii) the types of Primary Contract of Purchase Coverage and Supplemental Contract of Purchase Coverage; and

(ix) the Loan Loss Requirement.

According to Resolution RB-1, the Department will not be in default under Resolution RB-1 merely because a Cash Flow Statement shows that projected Revenues will be insufficient to provide for timely payments of interest on and principal of the Revenue Bonds and Expenses, but is required to take all reasonable actions to eliminate such deficiency.

The Program Operating Procedures are operating policies of the Department governing discretionary activities under Resolution RB-1. Resolution RB-1 requires the Department to administer the Program and perform its obligations under Resolution RB-1 in accordance in all material respects with the then-current Program Operating Procedures. The Program Operating Procedures may be amended if (1) a Cash Flow Statement is delivered to the Trustee and (2) an opinion of nationally recognized bond counsel is delivered to the Trustee to the effect that such amendment or action taken pursuant to such amendment will not affect the exemption of interest on the Revenue Bonds from the gross income of the holders thereof for Federal income tax purposes.

#### **Cash Flow Statements to be Delivered in Connection with the Offered Revenue Bonds**

As a condition to the issuance of the Offered Revenue Bonds, the Department will provide the Trustee with its Cash Flow Statement in the form required by Resolution RB-1. The Cash Flow Statement will consist of the conclusion by an Authorized Representative of the Department that projected Revenues will be sufficient to provide for timely payments of scheduled interest and principal on the Revenue Bonds and Expenses, under each of the scenarios included in the cash flow projections attached thereto (the "Issuance Cash Flow Projections"). The Issuance Cash Flow Projections will be prepared by cfX Incorporated ("cfX"), pursuant to its engagement as Quantitative Consultant to the Department. The Issuance Cash Flow Projections and the conclusions of cfX contained in its accompanying cash flow letter will be based solely on information provided to cfX by the Department and the Trustee and certain assumptions provided to cfX by the Department and upon scenarios generally specified by the Rating Agencies to be tested; cfX makes no representation with respect to the accuracy of such information or as to the reasonableness of such assumptions and scenarios.

The Issuance Cash Flow Projections will be based on the financial condition of the 1943 Fund as of December 31, 2004 and will reflect significant financial transactions within the 1943 Fund through February 28, 2005, as explained to cfX by the Department. The Issuance Cash Flow Projections will reflect (i) the assumed delivery of the Offered Revenue Bonds and the 2005 G.O. Bonds as part of the overall financing plan (but no additional future issuance of either Revenue Bonds or Veterans G.O. Bonds) and (ii) the initial application of proceeds of

such bonds in accordance with the Department's expected terms of the Sixteenth Supplemental Resolution and resolutions of issuance.

The Issuance Cash Flow Projections will include each of the scenarios generally specified and included in the final presentations to the Rating Agencies in connection with the Department's application for an appropriate rating on the Offered Revenue Bonds. Such scenarios reflect a combination of assumptions required by the Rating Agencies to be used with respect to future market conditions and behavior of eligible and participating veterans under such market conditions. cfX makes no representation with respect to the sufficiency of Revenues to provide for timely payments of interest and principal on the Revenue Bonds and Expenses under any scenario not presented in the Issuance Cash Flow Projections. Among other assumptions, the Issuance Cash Flow Projections will include alternative scenarios under which:

- (i) No future prepayments are received with respect to Contracts of Purchase, or, alternatively, that prepayments are received at a number of specified annualized constant prepayment rates.

- (ii) As of specified dates, no additional Contracts of Purchase are funded and unexpended amounts are applied to the redemption of Revenue Bonds and Veterans G.O. Bonds.

- (iii) A specified level of unreimbursed losses is incurred with respect to defaulted Contracts of Purchase.

Each scenario in the Issuance Cash Flow Projections will reflect future transactions expected to be executed by the Department and the Trustee (among others) with respect to: (i) the application for Program purposes of amounts in the Proceeds Account established under Resolution RB-1, (ii) the collection and deposit of Revenues, (iii) the investment of amounts on deposit in various Accounts in both specified and unspecified investments, (iv) the transfer of funds between Accounts, (v) the payment of Expenses and (vi) the redemption of Revenue Bonds and Veterans G.O. Bonds. The Cash Flow Projections do not address payment of purchase price upon any optional or mandatory tenders. All of the scenarios included in Issuance Cash Flow Projections assume that the Department and the Trustee execute such transactions on a timely basis in conformance with the requirements of Resolution RB-1, the Sixteenth Supplemental Resolution, the Series Resolutions authorizing the issuance of prior and future Series of Revenue Bonds, the Program Operating Procedures, and the providers of third party investment contracts. cfX can provide no assurance that such actions will be timely taken.

Each scenario in the Issuance Cash Flow Projections will reflect future performance by third parties under investment and insurance contracts and will assume no default in performance. Each scenario will also assume that, with the exception of reserves and liabilities reflected on the 1943 Fund audited financial statements as of June 30, 2004, future operations of the life and disability insurance and property insurance programs offered by the Department will neither contribute to, nor require support from, the 1943 Fund.

The Cash Flow Statement and the Issuance Cash Flow Projections have not been and will not be verified for mathematical accuracy by an independent auditor.

## Maintenance of Fund Parity

Resolution RB-1 requires that the Department cause a calculation to be made of Fund Parity, as evidenced in a Certificate of the Department filed with the Trustee as of the last day of each Fiscal Year (and upon receipt of the audited financial statements of the 1943 Fund), or more frequently in the discretion of the Department. If any such calculation shall not reflect that Fund Parity at least equals 25% (or such other percentage which may be set forth in the future in the Program Operating Procedures provided that any percentage which is less than 25% shall be the subject of a Rating Confirmation) (the "Applicable Fund Parity Percentage") of the then outstanding principal amount of Revenue Bonds, all Revenues in excess of Accrued Debt Service on the Revenue Bonds and Veterans G.O. Bonds shall thereafter be applied to redeem Revenue Bonds of the Series and in the manner reflected in a current Cash Flow Statement, until (and if) the Department files with the Trustee a new Certificate of the Department reflecting a calculation of Fund Parity that at least equals such Applicable Fund Parity Percentage; *provided, further, however*, that no such Cash Flow Statement and no such redemption shall be required if the Department shall have provided a Rating Confirmation to the Trustee. The Department Certificate filed as of June 30, 2004 reflected Fund Parity in excess of the Applicable Fund Parity Percentage, which was 25%.

Under Resolution RB-1, "Fund Parity" means, on any determination date: (a) an amount equal to the difference between (i) all assets in the 1943 Fund and in the Accounts established under Resolution RB-1 and any Series Resolution or Supplemental Resolution and (ii) the principal amount of all Revenue Bonds Outstanding and all Veterans G.O. Bonds outstanding (plus accrued interest), reduced by (b) allowances and reserves for loss coverage on Contracts of Purchase, and life and disability coverage on persons obligated under Contracts of Purchase, as specified in the Program Operating Procedures.

Resolution RB-1 provides that "Accrued Debt Service" means, as of any date of determination and, as the context of Resolution RB-1 requires, with respect to all Revenue Bonds and Veterans G.O. Bonds, the sum of:

(a) the aggregate amount of scheduled interest and principal (except to the extent principal is otherwise to be redeemed pursuant to clause (b) or (c) below) to become due after such date but on or before the end of the current Debt Service Year, less the product of (i) the number of whole months remaining in the current Debt Service Year and (ii) the Monthly Debt Service Requirement;

(b) the redemption price of bonds for which notice of redemption has been issued, provided such redemption price is to be paid from amounts on deposit in the Revenue Account; and

(c) the redemption price of bonds that the Department will be obligated to redeem prior to the end of the next succeeding Debt Service Year under the terms of any Series Resolution or Supplemental Resolution or resolution of issuance governing Veterans G.O. Bonds, to the extent that such obligation arises on account of amounts on deposit in the Revenue Account.

Under Resolution RB-1, “Monthly Debt Service Requirement” means, as of any date of determination, one-twelfth of the aggregate amount of scheduled interest and principal to become due during the Debt Service Year in which such date falls, as computed on the first day of such Debt Service Year.

### **Additional Revenue Bonds**

Resolution RB-1 permits the issuance of Series of Additional Revenue Bonds to carry out the provisions of the Act and other statutes enacted in support of the Program or to refund all or part of the Revenue Bonds or Veterans G.O. Bonds then Outstanding. Any Series of Additional Revenue Bonds issued under Resolution RB-1 (except for bonds which are subordinate obligations) will be on a parity with the then Outstanding Revenue Bonds, and will be entitled to the equal benefit, protection and security of the provisions, covenants and agreements of Resolution RB-1. Additional Revenue Bonds may have interest payment dates which differ from those of the Outstanding Revenue Bonds and the Offered Revenue Bonds. Upon the issuance of any such Series of Additional Revenue Bonds, Resolution RB-1 requires the deposit into the Bond Reserve Account and the Loan Loss Account such amounts as are necessary to increase the amounts therein to, respectively, the Bond Reserve Requirement or the Loan Loss Requirement. Such deposit may be made from the 1943 Fund, the proceeds of sale of the Series of Additional Revenue Bonds or any other lawful source, or through the use of Cash Equivalents as provided in the Series Resolution authorizing the issuance of the Series of Additional Revenue Bonds. Under Resolution RB-1, issuance of Additional Revenue Bonds is conditioned upon delivery of a Cash Flow Statement and Rating Confirmation and upon certification that no Event of Default under Resolution RB-1 shall have occurred and be continuing.

Additional Veterans G.O. Bonds authorized by the voters of the State may be issued by the State from time to time to provide funds for the Program or to refund outstanding Veterans G.O. Bonds, subject to the delivery of a Cash Flow Statement. See “SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS – The 1943 Fund” for a discussion of authorized but unissued bonds.

## **SELECTED FINANCIAL DATA OF THE 1943 FUND AND DEPARTMENT’S DISCUSSION**

### **Selected Financial Data of the 1943 Fund**

The following table (the “Selected Financial Data”) contains selected financial data of the 1943 Fund for fiscal years ended June 30, 2004 and 2003 which has been derived from the financial statements of the 1943 Fund audited by Deloitte & Touche LLP, independent auditors, whose report thereon appears in APPENDIX A-1 in this Official Statement, and the Department’s accounting records. The Selected Financial Data also contains the comparable financial data of the 1943 Fund for fiscal years ended June 30, 2002, 2001 and 2000, which has been derived from the audited financial statements of the 1943 Fund that are not included herein, and the Department’s accounting records for those years. In addition, the Selected Financial Data contains the comparable financial data of the 1943 Fund for the six month periods ended December 31, 2004 and December 31, 2003, which has been derived from the un-audited financial statements of the 1943 Fund that appear in APPENDIX A-2 in this Official Statement,



and the Department's accounting records for those periods. **This selected financial data should be read in conjunction with the financial statements and notes thereto of the 1943 Fund contained in said APPENDIX A-1 and APPENDIX A-2 and the Department's Discussion of Financial Data contained herein.**

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**SELECTED FINANCIAL DATA OF THE 1943 FUND**  
(Dollars in Thousands)

	6 Months Ending Dec. 31, 2004 ***	6 Months Ending Dec. 31, 2003 ***	June 30, 2004	June 30, 2003	For Fiscal Years Ending on		
					June 30, 2002	June 30, 2001	June 30, 2000
<b>ASSETS AND LIABILITIES RELATED TO LENDING AND FINANCING ACTIVITIES:</b>							
<b>CASH AND INVESTMENTS</b>							
Cash and amounts on Deposit in SMIF*	\$ 380,570	\$ 829,375	\$ 589,654	\$728,511	\$515,052	\$324,158	\$226,076
Guaranteed Investment Contracts	157,136	285,593	154,890	265,595	363,685	319,476	562,380
Treasury Securities	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>112,107</u>
Total	537,706	1,114,968	744,544	994,106	878,737	643,634	900,563
DUE FROM VETERANS DEBENTURE REVENUE FUND	37,568	39,068	37,532	37,411	37,346	40,905	33,847
OTHER CURRENT ASSETS	10,790	12,980	10,504	14,517	20,620	30,333	30,903
NET OTHER NON-CURRENT ASSETS	4,601	4,042	10,160	4,751	6,120	33,329	33,255
<b>CONTRACTS OF PURCHASE</b>							
Performing Contracts	1,536,398	1,571,084	1,536,490	1,766,419	2,356,055	2,605,059	2,418,292
Non Performing Contracts	<u>2,826</u>	<u>5,389</u>	<u>2,987</u>	<u>6,248</u>	<u>9,543</u>	<u>18,182</u>	<u>16,764</u>
Total	1,539,224	1,576,473	1,539,477	1,772,667	2,365,598	2,623,241	2,435,056
Allowance For Contract Losses	(8,540)	(10,040)	8,540	(10,040)	(14,135)	(16,715)	(19,676)
Reduction of REO to Fair Value	<u>(527)</u>	<u>(1,020)</u>	<u>(527)</u>	<u>(1,020)</u>	<u>(2,300)</u>	<u>(2,592)</u>	<u>(3,050)</u>
Total	<u>(9,067)</u>	<u>(11,060)</u>	<u>(9,067)</u>	<u>(11,060)</u>	<u>(16,435)</u>	<u>(19,307)</u>	<u>(22,726)</u>
<b>BONDS PAYABLE</b>							
General Obligation Bonds	(1,270,685)	(1,812,850)	(1,433,190)	(1,979,685)	(2,346,930)	(2,415,765)	(2,528,330)
Revenue Bonds	<u>(575,845)</u>	<u>(627,835)</u>	<u>(617,445)</u>	<u>(521,475)</u>	<u>(548,210)</u>	<u>(570,940)</u>	<u>(505,815)</u>
Total	<u>(1,846,530)</u>	<u>(2,440,685)</u>	<u>(2,050,635)</u>	<u>(2,501,160)</u>	<u>(2,895,140)</u>	<u>(2,986,705)</u>	<u>(3,034,145)</u>
OTHER CURRENT LIABILITIES	<u>(21,679)</u>	<u>(20,233)</u>	<u>(22,312)</u>	<u>(19,261)</u>	<u>(90,047)</u>	<u>(60,081)</u>	<u>(87,598)</u>
Net Lending & Financing Activities Assets	<u>252,613</u>	<u>275,553</u>	<u>260,203</u>	<u>291,971</u>	<u>306,799</u>	<u>305,349</u>	<u>289,155</u>
<b>ASSETS AND LIABILITIES RELATED TO INSURANCE ACTIVITIES:</b>							
<b>LIFE AND DISABILITY COVERAGE</b>							
Cash Reserve for Life and Disability	609	4,417	2,388	6,387	9,875	16,289	23,010
Insurance Loss Reserves	<u>(17,600)</u>	<u>(19,900)</u>	<u>(17,600)</u>	<u>(19,900)</u>	<u>(22,653)</u>	<u>(26,726)</u>	<u>(31,642)</u>
Total	(16,991)	(15,483)	(15,212)	(13,513)	(12,778)	(10,437)	(8,632)
RATE STABILIZATION RESERVE FOR LIFE AND DISABILITY PREMIUMS**	5,000	0	5,000	0	0	(5,700)	(5,700)
<b>FIRE AND HAZARD COVERAGE</b>							
Deposits with Insurance Administrators	1,050	1,850	1,850	1,850	1,850	1,850	1,850
Accrued Liabilities	<u>(1,891)</u>	<u>(2,225)</u>	<u>(2,512)</u>	<u>(2,035)</u>	<u>(1,950)</u>	<u>(3,016)</u>	<u>(3,236)</u>
Total	<u>(841)</u>	<u>(375)</u>	<u>(662)</u>	<u>(185)</u>	<u>(100)</u>	<u>(1,166)</u>	<u>(1,386)</u>
Net Insurance Activities Liabilities	<u>(12,832)</u>	<u>(15,858)</u>	<u>(10,874)</u>	<u>(13,698)</u>	<u>(12,878)</u>	<u>(17,303)</u>	<u>(15,718)</u>
<b>RETAINED EARNINGS</b>	<u>\$ 239,781</u>	<u>\$ 259,695</u>	<u>\$ 249,329</u>	<u>\$ 278,273</u>	<u>\$ 293,921</u>	<u>\$ 288,046</u>	<u>\$ 273,437</u>
<b>SUMMARY INFORMATION</b>							
Total Assets	\$ 2,127,000	\$ 2,743,000	\$2,342,000	\$ 2,821,000	\$ 3,304,000	\$ 3,344,000	\$ 3,411,000
Total Liabilities	\$ 1,888,000	\$ 2,483,000	2,093,000	\$ 2,542,000	\$ 3,010,000	\$ 3,056,000	\$ 3,137,000
Total # of Contracts of Purchase	17,643	20,130	18,699	22,397	28,605	32,473	33,440

\*Surplus Money Investment Fund

\*\*Reclassification for Liabilities which was reversed in Fiscal Year 2002

\*\*\*6 Months unaudited financial information. GASB adjustments from prior fiscal year were carried over and not updated.

**SELECTED FINANCIAL DATA OF THE 1943 FUND**  
**(Dollars in Thousands)**

	6 Months Ending Dec. 31, 2004 ***	6 Months Ending Dec. 31, 2003 ***	For Fiscal Years Ending on				
			June 30, 2004	June 30, 2003	June 30, 2002	June 30, 2001	June 30, 2000
<b>NET INCOME FROM LENDING AND FINANCING ACTIVITIES:</b>							
INTEREST INCOME							
Interest on Contracts	\$ 46,509	\$ 52,551	\$100,676	\$ 140,036	\$ 166,086	\$ 179,755	\$ 150,213
Interest on Investments	8,553	14,314	23,613	34,142	38,107	40,194	69,471
Transfers of Interest From Veterans Debtenture Revenue Fund	<u>1,019</u>	<u>1,002</u>	<u>2,009</u>	<u>2,029</u>	<u>2,403</u>	<u>2,219</u>	<u>1,476</u>
Total	56,081	67,867	126,298	176,207	206,596	222,168	221,160
BOND INTEREST EXPENSE	<u>(56,230)</u>	<u>(73,204)</u>	<u>(136,882)</u>	<u>(169,143)</u>	<u>(184,654)</u>	<u>(188,017)</u>	<u>(193,495)</u>
<b>Net Interest Income</b>	<b><u>(149)</u></b>	<b><u>(5,337)</u></b>	<b><u>(10,584)</u></b>	<b><u>7,064</u></b>	<b><u>21,942</u></b>	<b><u>34,151</u></b>	<b><u>27,665</u></b>
RESERVE FOR RATE STABILIZATION	0	0	0	0	0	0	(5,700)
GASB 31 ADJUSTMENT	215	532	215	532	554	351	479
GAIN ON SALE OF SECURITIES	0	0	0	0	0	1,130	270
RESTRUCTURING EXPENSES	<u>(1,015)</u>	<u>(3,300)</u>	<u>(8,164)</u>	<u>(5,826)</u>	<u>(4,780)</u>	<u>(3,642)</u>	<u>(2,629)</u>
Total	<u>(800)</u>	<u>(2,768)</u>	<u>(7,949)</u>	<u>(5,294)</u>	<u>(4,226)</u>	<u>(2,161)</u>	<u>(7,580)</u>
CONTRACTS OF PURCHASE							
PMI	(1,066)	(1,672)	(2,991)	(1,845)	(2,565)	(7,658)	(86)
Net gain (loss) on Sale of REO'S	254	887	1,173	2,092	1,730	55	(2,683)
(Increase) Decrease in Allowance for Contract Losses	<u>0</u>	<u>0</u>	<u>1,993</u>	<u>5,375</u>	<u>2,872</u>	<u>3,420</u>	<u>6,641</u>
Total	(812)	(785)	175	5,622	2,037	(4,183)	3,872
<b>Net Lending/Financing Activities Income (Expense)</b>	<b><u>(1,761)</u></b>	<b><u>(8,890)</u></b>	<b><u>(18,358)</u></b>	<b><u>7,392</u></b>	<b><u>19,753</u></b>	<b><u>27,807</u></b>	<b><u>23,957</u></b>
<b>NET INCOME FROM ADMINISTRATIVE ACTIVITIES</b>							
Operating Revenues	3,116	4,235	7,967	5,813	4,417	8,128	5,779
Operating Expenses	<u>(10,194)</u>	<u>(11,302)</u>	<u>(21,918)</u>	<u>(25,396)</u>	<u>(20,353)</u>	<u>(21,541)</u>	<u>(23,902)</u>
<b>Net Administrative Activities Expense</b>	<b><u>(7,078)</u></b>	<b><u>(7,067)</u></b>	<b><u>(13,951)</u></b>	<b><u>(19,583)</u></b>	<b><u>(15,936)</u></b>	<b><u>(13,413)</u></b>	<b><u>(18,123)</u></b>
<b>NET INCOME FROM INSURANCE ACTIVITIES</b>							
Life and Disability Coverage	(1,751)	(2,130)	4,194	(1,568)	896	(2,571)	(3,374)
Fire and Hazard Coverage	<u>1,003</u>	<u>(149)</u>	<u>(829)</u>	<u>(1,889)</u>	<u>1,162</u>	<u>2,786</u>	<u>1,408</u>
<b>Net Insurance Activities Income (Expense)</b>	<b><u>(748)</u></b>	<b><u>(2,279)</u></b>	<b><u>3,365</u></b>	<b><u>(3,457)</u></b>	<b><u>2,058</u></b>	<b><u>215</u></b>	<b><u>(1,966)</u></b>
<b>TOTAL EXCESS (DEFICIENCY) OF REVENUES AND TRANSFERS OVER EXPENSES</b>	<b><u>(9,587)</u></b>	<b><u>(18,236)</u></b>	<b><u>(28,944)</u></b>	<b><u>(15,648)</u></b>	<b><u>5,875</u></b>	<b><u>14,609</u></b>	<b><u>3,868</u></b>
RETAINED EARNINGS	\$ 239,781	\$ 259,695	\$249,329	\$ 278,273	\$ 293,921	\$ 288,046	\$ 273,437

\*\*\* 6 Months unaudited financial information. GASB adjustments from prior fiscal year were carried over and not updated.

## **Department's Discussion of Financial Data**

Included as part of the financial statements contained in Appendix A-1 is the section entitled "Management's Discussion and Analysis of Financial Position and Results of Operations" which presents management's discussion in relation to the financial statements of the 1943 Fund for the fiscal year ended June 30, 2004 and in comparison to the financial statements for the fiscal year ended June 30, 2003 (the "Management Discussion and Analysis"). The Selected Financial Data is presented to provide a summary of the financial position and operations over a longer period of time, and a presentation of the significant changes that have occurred. Certain limited aspects of the Selected Financial Data are discussed below. This discussion should be read in conjunction with the Management Discussion and Analysis contained in APPENDIX A-1 and with APPENDIX C entitled "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA."

The Selected Financial Data reflects the onset in the second half of the fiscal year ended June 30, 2002 of adverse conditions in the capital market environment in which the 1943 Fund operates – historically low levels of interest rates on conventional mortgages, and even lower levels of interest rates on short term money market instruments. In part as a consequence of prepayments of Contracts of Purchase refinanced by lower rate conventional mortgages, and in part as a consequence of new originations of Contracts of Purchase lost to highly competitive conventional mortgages, Contracts of Purchase held under the 1943 Fund declined by \$826,121,000 over the next two fiscal years, from \$2,365,598,000 as of June 30, 2002 to \$1,539,477,000 as of June 30, 2004. The impact of this shrinkage in the assets of the 1943 Fund was compounded by adverse turnover of the portfolio, with the more rapid prepayment of higher interest rate Contracts of Purchase, and the origination of new Contracts of Purchase at progressively lower interest rates. In the fiscal year ended June 30, 2002, the average interest rate on outstanding Contracts of Purchase was approximately 6.8%; in the fiscal year ended June 30, 2004, the average interest rate had fallen to approximately 6.4%.

Over the same two fiscal years, as a result of the use of significant amounts of prepayments and unexpended proceeds to redeem bonds, the balance of Veterans G.O. Bonds and Revenue Bonds payable from the 1943 Fund declined by \$844,505,000, from \$2,895,140,000 as of June 30, 2002, to \$2,050,635,000 as of June 30, 2004. To a limited extent, the adverse turnover to the asset portfolio was offset by the Department's priority selection (subject to the requirements of the Resolution) of the higher interest rate Veterans G.O. Bonds for Special Redemption. In the fiscal year ended June 30, 2002, the average interest rate on outstanding Veterans G.O. Bonds and Revenue Bonds was approximately 6.15%; in the fiscal year ended June 30, 2004, the average interest rate had fallen to approximately 6.00%.

The Department's ability to reduce the overall interest cost of Veterans G.O. Bonds and Revenue Bonds was limited by its inability to redeem any of the outstanding Veterans G.O. Bonds issued prior to 1986 (the "Non-Callable Bonds"). The Non-Callable Bonds, of which \$592,055,000 and \$459,970,000 were outstanding as of June 30, 2002 and June 30, 2004, respectively, mature in installments through October 1, 2010, and bear an average interest rate of over 9%. Notwithstanding this short term fixed repayment schedule, the early redemption of other Veterans G.O. Bonds resulted in the increase in the Non-Callable Bonds as percentage of the outstanding Veterans G.O. Bonds from approximately 25% as of June 30, 2002, to

approximately 32% as of June 30, 2004. Exclusive of the Non-Callable Bonds, the average interest rate on outstanding Veterans G.O. Bonds and Revenue Bonds was approximately 5.35% in the fiscal year ended June 30, 2002, and had fallen to approximately 5.14% in the fiscal year ended June 30, 2004.

While the decline in the balance of Contracts of Purchase over the two year period was offset by a corresponding decline the amount of Veterans G.O. Bonds and Revenue Bonds payable, repayments of Contracts of Purchase were invested in the 1943 Fund temporarily pending use for the payment or redemption of bonds (with Qualified Veterans Mortgage Bond Proceeds and Qualified Mortgage Bond Proceeds) or for the financing of new Contracts of Purchase (with Unrestricted Moneys). In the case of the Unrestricted Moneys, repayments significantly exceeded new originations over the two year period ended June 30, 2004, resulting in an accumulation of cash, much of which (generally amounts not related to bonds for federal tax purposes) was deposited in the SMIF. As of June 30, 2003, the total amount on deposit in the SMIF was \$728,511,000, an increase of \$213,459,000 over the amount on deposit as June 30, 2002 (which itself represented a significant increase over the prior year). As the deposits grew, the impact became increasingly negative as short term interest rates generally declined, and as the SMIF yields followed. In the fiscal year ended June 30, 2002, the average yield paid to depositors in SMIF was approximately 3.4%; in the fiscal year ended June 30, 2004, this average yield had fallen to approximately 1.5%.

The contraction of the balance sheet, the shift in the mix of assets, and the decline (or inversion) of the spreads between asset yields and bond rates have all contributed to a significant and rapid deterioration of the financial performance of the 1943 Fund over the two year period. These factors are directly reflected in net interest, which reversed from a net income of \$21,942,000 for the year ended June 30, 2002 to a net loss of \$10,584,000 for the year ended June 30, 2004. In addition, as a result of the increase in early redemption of Veterans G.O. Bonds and Revenue Bonds, non-cash amortization expense related to the previously expended costs of issuing and restructuring bonds has increased steadily from \$4,780,000 for the year ended June 30, 2002, to \$8,164,000 for the year ended June 30, 2004. Total excess (deficiency) of revenues and transfers over expenses has deteriorated correspondingly.

Notwithstanding the negative impact of the recent periods on retained earnings, which declined from \$293,921,000 as of June 30, 2002 to \$249,329,000 as of June 30, 2004, the amount of retained earnings of the 1943 Fund has continued to improve in relationship to outstanding assets and liabilities. The overall asset-to-liability ratio for the 1943 Fund increased steadily from 109.8% as of June 30, 2002, to 111.9 % as of June 30, 2004.

Since December 31, 2003, the financial performance of the 1943 Fund has benefited from both the improvement in the market environment and the implementation by the Department of additional strategies to mitigate that impact of adverse market conditions. As a result of less competitive conditions in the conventional mortgage market, the balance of Contracts of Purchase held under the 1943 Fund as of December 31, 2004 was unchanged from six months earlier, and had declined by only \$33,185,000 from a year earlier. Interest rates on newly originated Contracts of Purchase had increased by approximately 90 basis points from their low at the start of the 2003/04 fiscal year. As a result of additional redemptions of bonds and

originations of Contracts of Purchase, the amount on deposit in SMIF was down to \$380,570,000 as of December 2004, from \$829,375,000 a year earlier. By December 2004, the average yield paid on deposits in SMIF had recovered to 2%.

In August 2003, the Department implemented the practice of utilizing Unrestricted Moneys (otherwise on deposit in SMIF) to finance Contracts of Purchase on a temporary basis, against reimbursement from the proceeds of future sales of Qualified Veterans Mortgage Bonds or Qualified Mortgage Bonds. As a result, the Department has achieved an immediate increase in the return on such Unrestricted Moneys. In December 2003, the Department issued the 2003 Series A Revenue Bonds, in variable rate mode, to refund prior fixed rate bonds. As a result, the Department matched the interest cost on a portion of its bonds to the variable earnings rate on a portion of the cash that remained on deposit in the SMIF. For the six months ended December 31, 2004, the net interest loss for the 1943 Fund was reduced to \$149,000, compared to the net interest loss of \$5,337,000 for the six month period ended December 31, 2003.

The ability of the Department to return to an excess of revenues over expenses in future periods will depend upon a variety of factors including, among others: (a) the level of interest rates available on short-term investments (including the rate paid on SMIF and on newly acquired investment contracts) relative to the level of interest rates on outstanding bonds; (b) the rate of origination and the rate of prepayment of Contracts of Purchase, which will directly impact the amount of bond proceeds, recycling funds and revenues held in such investments; (c) the interest rates established from time to time by the Department for newly originated Contracts of Purchase relative to the interest cost on bonds issued to finance such Contracts of Purchase; (d) the interest rates on outstanding Contracts of Purchase relative to the interest cost on outstanding bonds, which will directly depend on the Department's ability to use special and optional redemption provisions to minimize the overall cost of outstanding debt (limited, over the near term by the Non-Callable Bonds); (e) the market prices that can be achieved upon the sale of repossessed properties relative to the then-outstanding contract balances; (f) the level of insurance premiums that the Department collects under its existing life and disability coverage plan and fire and hazard coverage plan relative to actual claims experience and costs (net of reinsurance); and (g) the level of administrative expenses relative to the rate of origination and outstanding balances of the Contracts of Purchase. The Department expects that there will be significant variations in results in future periods, including additional periods in which there will be a deficit of revenues over expenses.

## **THE OFFERED REVENUE BONDS**

### **General**

The Offered Revenue Bonds will be issued as fully-registered bonds in initial denominations of \$5,000 or any integral multiple thereof in book-entry form. The Offered Revenue Bonds will mature in the years and bear interest at the rates set forth on the cover page hereof.

The Offered Revenue Bonds are subject to redemption prior to maturity, as described herein.

## Interest on the Offered Revenue Bonds

Interest accrued on the Offered Revenue Bonds will accrue from the Dated Date (as shown on the cover page hereof) at the respective rates shown on the cover page of this Official Statement. Interest on the Offered Revenue Bonds will be payable on June 1 and December 1 of each year beginning December 1, 2005.

## Redemption

### *Optional Redemption*

The Offered Revenue Bonds shall be subject to optional redemption, in whole or in part on any date on or after June 1, 2015 from any moneys made available for such purpose, at a redemption price equal to 100% of the Outstanding principal amount of the Offered Revenue Bonds to be redeemed, without premium, plus interest accrued thereon to the redemption date.

### *Redemption from Mandatory Sinking Account Payments*

The Offered Revenue Bonds maturing on December 1, 2025 and December 1, 2027 (the “Term Bonds”) are subject to mandatory redemption prior to their stated maturities, in part, by lot, at a redemption price equal to 100% of the principal amount thereof plus accrued interest to the date fixed for redemption, without premium, from Mandatory Sinking Account Payments, on the respective dates and in the respective amounts as follows:

### Offered Revenue Bonds Maturing December 1, 2025

<b>Date (December 1)</b>	<b>Mandatory Sinking Account Payments</b>
2019	\$ 2,395,000
2020	2,540,000
2021	2,700,000
2022	2,865,000
2023	3,045,000
2024	3,235,000
2025†	3,435,000

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† Stated maturity

### Offered Revenue Bonds Maturing December 1, 2027

<b>Date</b> <b><u>(December 1)</u></b>	<b>Mandatory Sinking</b> <b><u>Account Payments</u></b>
2026	\$ 3,650,000
2027 <sup>†</sup>	3,885,000

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<sup>†</sup> Stated maturity

Pursuant to the Resolution, if less than all of the Term Bonds of a maturity are purchased or called for redemption (other than in satisfaction of Mandatory Sinking Account Payments), the Trustee will credit the principal amount of such Term Bonds that are so purchased or redeemed against applicable remaining Mandatory Sinking Account Payments (including the principal amounts due on the respective maturity dates, as shown above) as directed by the Department or, if no direction is given, then against all applicable remaining Mandatory Sinking Account Payments in the proportion that the then-remaining balance of each such Mandatory Sinking Account Payment (including the principal amount due on the respective maturity date, as shown above) bears to the total of all applicable Mandatory Sinking Account Payments (including the principal amounts due on the respective maturity dates, as shown above).

#### *Special Redemption from Excess Revenues*

The Offered Revenue Bonds are subject to special redemption at the option of the Department in whole or in part at any time, at a redemption price equal to 100% of the principal amount thereof plus interest accrued thereon to the date fixed for redemption in an amount equal to Excess Revenues. The Offered Revenue Bonds to be so redeemed shall be such maturities, and such amounts within a maturity, as shall be selected by the Department. The Offered Revenue Bonds are not subject to redemption from unexpended bond proceeds.

Excess Revenues (defined in "SUMMARY OF CERTAIN PROVISIONS OF THE RESOLUTION – Definitions (Section 103)") can include prepayments and repayments on Contracts of Purchase funded by Revenue Bonds and Veterans G.O. Bonds, investment earnings and insurance receipts, and also includes Revenues which had been set aside to be recycled into new Contracts of Purchase. A portion of the proceeds of the 2005 G.O. Bonds will be used to reimburse the Department for its prior funding of existing Contracts of Purchase. Such amounts will be deposited to a Recycling Subaccount. The Department presently plans to apply such funds to fund additional Contracts of Purchase. To the extent that such monies are not applied to the funding of additional Contracts of Purchase, as Revenues they will be applied in accordance with the Resolution, including application as Excess Revenues.

See "THE OFFERED REVENUE BONDS – Redemption – Information Regarding Prepayments" for additional information regarding prepayments of Contracts of Purchase.

All payments on Contracts of Purchase are deposited in the 1943 Fund and applied to pay or reimburse debt service on the Veterans G.O. Bonds, to pay debt service on Revenue Bonds, to



pay for mandatory redemptions of Veterans G.O. Bonds and Revenue Bonds, to pay Program and Department expenses, and to pay certain insurance claims. The Department, subject to applicable bond authorizing resolutions, may apply Excess Revenues to redeem any Veterans G.O. Bonds or Revenue Bonds eligible for redemption. The Department's decision to apply Excess Revenues to redeem bonds, to finance new Contracts of Purchase, or to any other permitted purpose depends on many factors, including applicable bond authorizing resolution requirements, demand for contracts of Purchase, debt service cost savings, investment earnings and Federal Tax Code requirements. See "THE OFFERED REVENUE BONDS – Redemption – Information Regarding Prepayments" for additional information regarding prepayments of Contracts of Purchase. Certain of the outstanding Veterans G.O. Bonds are not subject to redemption prior to maturity. See APPENDIX D – "Certain Department Financial Information and Operating Data – Veterans G.O. Bonds and Revenue Bonds – Selected Information With Respect to Veterans G. O. Bonds and Revenue Bonds."

#### *Information Regarding Prepayments*

The Department's actual past prepayment experience for existing Contracts of Purchase is set forth in APPENDIX C – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Contracts of Purchase Origination and Principal Repayment Experience."

For qualified mortgage bonds (which do not include pre-Ullman bonds, including the Offered Revenue Bonds) issued or to be issued after 1988, the Federal Tax Code prohibits repayments (including prepayments) of principal of Contracts of Purchase financed with the proceeds of an issue of such bonds to be used to make additional Contracts of Purchase after 10 years from the date of issuance of such bonds (or the date of issuance of original bonds in the case of refundings), after which date such amounts must be used to redeem such bonds of the issue, except for a \$250,000 *de minimis* amount. See "TAX MATTERS – Federal Tax Matters."

The Federal Tax Code requires a payment to the United States from certain veterans whose Contracts of Purchase are originated after December 31, 1990 with the proceeds of qualified mortgage bonds (which do not include pre-Ullman bonds, including the Offered Revenue Bonds). Since such requirement remains in effect with respect to any Contracts of Purchase originated after December 31, 1990 with proceeds of the applicable Revenue Bonds, for a period ending nine years after the execution of such Contracts of Purchase, the Department is unable to predict what effect, if any, such requirement will have on the origination or prepayment of Contracts of Purchase to which such provision applies.

#### **Redemption Notice**

The Resolution requires that at least fifteen (15) but not more than ninety (90) days before a redemption date for Revenue Bonds, the Trustee must cause a notice of any such redemption to be mailed, first class prepaid, to registered owners of the Revenue Bonds which are the subject of the redemption at the addresses appearing on the registration books maintained by the Trustee, as Bond Registrar. In addition, if the notice of redemption is conditional, the notice must set forth in summary terms the conditions precedent to such redemption and that if such conditions shall not have been satisfied on or prior to the redemption date, said notice shall

be of no force and effect and such Revenue Bonds will not be so redeemed. No defect in the notice of redemption or mailing thereof (including any failure to mail such notice) to any owner of Revenue Bonds will affect the validity of the redemption proceedings for any other owner of Revenue Bonds subject to such redemption.

### **BOOK-ENTRY ONLY SYSTEM**

The information concerning DTC and DTC's book-entry system has been obtained from sources that the Department believes to be reliable, but the Department, the Trustee and the Underwriters take no responsibility for the accuracy or completeness thereof.

DTC will act as securities depository for the Offered Revenue Bonds. The Offered Revenue Bonds will be issued as fully-registered securities registered in the name of Cede & Co. (DTC's partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully registered Offered Revenue Bond certificate will be issued for each maturity of the Offered Revenue Bonds in the aggregate principal amount of such maturity, and will be deposited with DTC. DTC, the world's largest depository, is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds and provides asset servicing for over 2 million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues and money market instruments from over 85 countries that DTC's participants ("Direct Participants") deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions, in deposited securities through electronic computerized book-entry transfers and pledges between Direct Participants' accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("DTCC"). DTCC, in turn, is owned by a number of Direct Participants of DTC and Members of the National Securities Clearing Corporation, Government Securities Clearing Corporation, MBS Clearing Corporation and Emerging Markets Clearing Corporation (NSCC, GSCC, MBSCC and EMCC, also subsidiaries of DTCC), as well as by the New York Stock Exchange, Inc., the American Stock Exchange, LLC, and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others such as securities brokers and dealers, banks, trust companies and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("Indirect Participants"). DTC has Standard & Poor's highest rating: AAA. The DTC applicable rules to its Direct Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at [www.dtcc.com](http://www.dtcc.com).

Purchases of the Offered Revenue Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the Offered Revenue Bonds on DTC's records. The ownership interest of each actual purchaser of each Offered Revenue Bond ("Beneficial Owner") is in turn to be recorded on the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchase. Beneficial

Owners are, however, expected to receive written confirmation providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Offered Revenue Bonds are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in Offered Revenue Bonds, except in the event that use of the book-entry system for the Offered Revenue Bonds is discontinued.

To facilitate subsequent transfers, all Offered Revenue Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co., or such other name as may be requested by an authorized representative of DTC. The deposit of Offered Revenue Bonds with DTC and their registration in the name of Cede & Co., or such other nominee, do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Offered Revenue Bonds; DTC's records reflect only the identity of the Direct Participants to whose accounts such Offered Revenue Bonds are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. Neither the Department nor the Trustee will have any responsibility or obligation to such Direct Participants and Indirect Participants or the persons for whom they act as nominees with respect to the Offered Revenue Bonds.

Beneficial Owners of the Offered Revenue Bonds may wish to take certain steps to augment the transmission to them of notices of significant events with respect to the Offered Revenue Bonds, such as redemptions, tenders, defaults, and proposed amendments to the Offered Revenue Bond documents. Beneficial Owners of the Offered Revenue Bonds may wish to ascertain that the nominee holding the Offered Revenue Bonds for their benefit has agreed to obtain and transmit notices to Beneficial Owners.

Redemption notices shall be sent to DTC. If less than all of a maturity of the Offered Revenue Bonds is being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such maturity to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to the Offered Revenue Bonds unless authorized by a Direct Participant in accordance with DTC's procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Department as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the Offered Revenue Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Without limiting the generality of the foregoing, the Department, the Trustee, and the Underwriters have no responsibility or liability for any aspects of the records relating to or

payments made on account of beneficial ownership, or for maintaining, supervising or reviewing any records relating to beneficial ownership, or interests in the Offered Revenue Bonds.

Principal, premium and interest payments on the Offered Revenue Bonds will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the Department or the Trustee, on payable dates in accordance with their respective holdings shown on DTC's records. Payments by Direct Participants and Indirect Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name" and will be the responsibility of such Participant and not of DTC (nor its nominee), the Trustee or the Department, subject to any statutory and regulatory requirements as may be in effect from time to time. Payment of principal and interest to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Trustee or the Department, disbursement of such payments to Direct Participants shall be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners shall be the responsibility of Direct and Indirect Participants.

The Department, the Trustee, and the Underwriters cannot and do not give any assurances that DTC, Direct Participants, Indirect Participants or others will distribute payments with respect to the Offered Revenue Bonds received by DTC or its nominee as the registered owner, or any prepayment or other notices, to the Beneficial Owners, or that they will do so on a timely basis, or that DTC will serve and act in the manner described in this Official Statement.

If the Department and the Trustee determine not to continue the DTC book-entry only system, or DTC discontinues providing its services with respect to the Offered Revenue Bonds and the Department and the Trustee do not select another qualified security depository, the Trustee shall deliver physical Offered Revenue Bond certificates to the Beneficial Owners. The Offered Revenue Bonds may thereafter be transferred upon the books of the Department by the registered owners, in person or by authorized attorney, upon surrender of Offered Revenue Bonds at the Office of the Trustee in Sacramento, California, accompanied by delivery of an executed instrument of transfer in a form approved by the Trustee and upon payment of any charges provided for in the Resolutions. Certificated Offered Revenue Bonds may be exchanged for Offered Revenue Bonds of other authorized denominations of the same aggregate principal amount and maturity at the Office of the Trustee in Sacramento, California, upon payment of any charges provided for in the Resolutions.

According to DTC, the foregoing information with respect to DTC has been provided for informational purposes only and is not intended to serve as a representation, warranty or contract modification of any kind.

#### **ESTIMATED APPLICATION OF OFFERED REVENUE BOND PROCEEDS**

The sources of funds and the uses thereof (exclusive of accrued interest) in connection with the Offered Revenue Bonds, after expected transfers and exchanges, are expected to be approximately as set forth below.

## SOURCES

Offered Revenue Bond proceeds	\$42,600,000.00
Available amounts in the 1943 Fund	<u>1,200,055.50</u>
TOTAL SOURCES	\$43,800,055.50

## USES

Payment of Refunded Bonds	\$42,600,000.00
Payment of Redemption Premium	426,000.00
Costs of issuance	344,000.00
Underwriters' compensation	<u>430,055.50</u>
TOTAL USES	\$43,800,055.50

## THE PROGRAM

### General

The Department began making low interest rate farm and home financing available to veterans after World War I, following the enactment by the California Legislature (the "Legislature") of the Veterans Farm and Home Purchase Act of 1921. In 1943, the Legislature enacted the Veterans Farm and Home Purchase Act of 1943 ("1943 Act") which modified the Program to meet new needs of veterans. The 1943 Act was superseded by the Veterans Farm and Home Purchase Act of 1974 ("1974 Act") which again modified the Program. The 1943 Act established the 1943 Fund in the State Treasury, which is the principal fund utilized by the Program.

Since its inception, the Program has assisted over 416,500 veterans to purchase farms and homes throughout the State through long-term housing and farm loans. The sales of revenue bonds (including Revenue Bonds) and Veterans G.O. Bonds, combined with surplus revenues under the Program not needed at any given time to meet the then-current bond retirement schedules and operating costs, have financed the purchase of farms and homes since the Program's inception. As of December 31, 2004, there were 17,643 Contracts of Purchase outstanding with a remaining principal balance of \$1,539,224,000. As of December 31, 2004 the Department had approximately 353 pending applications for Contracts of Purchase in the approximate total principal amount of \$74,509,000. See APPENDIX C – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase" and "– Amounts Expected to be Available to Finance Contracts of Purchase and Related Investments" for information regarding existing Contracts of Purchase and moneys available to finance additional Contracts of Purchase.

The description of the Program under this heading is a description of the Program as it currently exists under the Veterans Code and the Department's implementation thereof. The Veterans Code and the Department's implementation of the Program are subject to change. The Program is also subject to the Federal Tax Code, as noted below.

## Qualifying Veteran Status

*Veterans Code.* A veteran must meet qualifications established under State law in the Veterans Code in order to participate in the Program. The qualifications specified in the Veterans Code are subject to change by the Legislature. The Veterans Code allows the Department to finance Contracts of Purchase for:

(a) veterans who have served, generally, at least ninety days on active duty in the Armed Forces of the United States, unless sooner discharged because of a service-connected disability, and received an honorable discharge or been released from active duty under honorable conditions during one of the following periods:

(i) April 6, 1917 through November 11, 1918; December 7, 1941 through December 31, 1946; or June 27, 1950 through January 31, 1955 (such veterans are referred to as "Earlier War Veterans");

(ii) February 28, 1961 through August 4, 1964 if the veteran served in the Republic of Vietnam during that period ("Early Vietnam Veterans"); or August 5, 1964 through May 7, 1975 (all veterans referred to in this clause (ii) are "Vietnam Era Veterans"); or

(iii) on or after August 2, 1990, through a date as yet to be determined by the President of the United States; at any time in Somalia, or in direct support of the troops in Somalia, during Operation Restore Hope; or at any time in an expedition or campaign for which a medal was authorized by the United States Government such as the Armed Forces Expeditionary and Vietnam Service Medals (such veterans are referred to as "Recent War Veterans");

(b) any member of the reserves or National Guard who is called to, and released from, active duty or active service, regardless of the number of days served, during any period when a presidential executive order specifies the United States is engaged in combat or homeland defense, and who received an honorable discharge or was released from active duty or active service under honorable conditions;

(c) any person who qualifies under the Federal Tax Code for financing from Revenue Bonds or unrestricted funds of the Department and who served in the active military, naval, or air service for a period of not less than ninety consecutive days and who received an honorable discharge or was released from active duty under honorable conditions (such veterans are referred to as "Peacetime Veterans"); and

(d) any person who qualifies under the Federal Tax Code for financing from Revenue Bonds or unrestricted funds of the Department and is at the time of application for benefits, a member of the California National Guard or a reserve component of any branch of the United States Armed Forces who has enlisted or been commissioned in that service for a period of not less than six years and has completed a minimum of one year of satisfactory service.

Amendments to the Veterans Code effective January 1, 1998 added Early Vietnam Veterans and Peacetime Veterans and amendments effective January 1, 2005 added those persons described in paragraphs (b) and (d) above as veterans eligible to receive Contracts of Purchase. These amendments, together with various financial and programmatic changes implemented by the Department, have significantly increased the universe of potential eligible veterans. See APPENDIX C – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA.”

*Federal Tax Code.* In order to determine which Department moneys can be used to finance Contracts of Purchase, the Department must also take into account the requirements of Federal law set forth in the Federal Tax Code, which limits the universe of veterans eligible to receive Contracts of Purchase financed from certain sources. See APPENDIX E – “CERTAIN FEDERAL TAX CODE REQUIREMENTS.” Applying the current Federal Tax Code separates the Department’s lendable moneys into three classes:

(a) “Unrestricted Moneys” (derived from certain moneys in the 1943 Fund, certain proceeds of pre-Ullman (as defined below) Revenue Bonds and Veterans G.O. Bonds, and certain future issues of taxable bonds, if any), which can finance Contracts of Purchase for those veterans who qualify under the applicable provisions of the Veterans Code (the QMB Loan Eligibility Requirements (defined below) do not apply to Contracts of Purchase financed by Unrestricted Moneys). The Department has implemented a policy (which is subject to change) to make Unrestricted Moneys available for Earlier War Veterans, Vietnam Era Veterans, Recent War Veterans and Peacetime Veterans. (“Pre-Ullman” refers to the period prior to enactment of Federal Tax Code programmatic restrictions on the use of proceeds of tax-exempt bonds to finance mortgage loans.);

(b) “Qualified Veterans Mortgage Bond Proceeds” (derived exclusively from proceeds of Veterans G.O. Bonds) which can finance Contracts of Purchase for any veteran who (i) qualifies under the Veterans Code; (ii) served on active duty prior to January 1, 1977; and (iii) was released from active duty fewer than 30 years before receiving such financing. The last date of veteran eligibility under clause (iii) is December 31, 2036 for a veteran with 30 years of continuous service after December 31, 1976. (The QMB Loan Eligibility Requirements (defined below) do not apply to Contracts of Purchase financed by moneys derived exclusively from proceeds of Veterans G.O. Bonds.) These proceeds can finance Contracts of Purchase for Earlier War Veterans and Vietnam Era Veterans; and

(c) “Qualified Mortgage Bond Proceeds” (which are principally derived from Revenue Bond proceeds other than pre-Ullman Revenue Bond proceeds), can finance Contracts of Purchase for any veteran who (i) qualifies under the Veterans Code, and (ii) satisfies certain requirements imposed by the Federal Tax Code principally limiting the family income of applicants and the property purchase price, and, subject to certain exceptions, requiring that the veteran not have had a present ownership interest in his principal residence in the three years prior to obtaining such financing (“QMB Loan Eligibility Requirements”).

## **Allocation of Lendable Moneys**

For veterans who qualify for Contracts of Purchase from two or more of the above-described financing sources, the Department may select the source of funds to be used in its sole discretion. The Department's goal is to maximize the availability of Program benefits. Current policy is that all veterans who qualify for Qualified Veterans Mortgage Bond Proceeds are funded from that source and all other eligible veterans are funded from Unrestricted Moneys. Available Qualified Veterans Mortgage Bond Proceeds recycling funds are used for National Guard or Reserves members who are only eligible for those funds under State law.

## **Administration of the Farm and Home Purchase Program**

The Department finances new and existing single-family homes, farms and mobile homes located in the State by acquiring the property selected by a veteran under a Contract of Purchase. The Department also finances home improvements with respect to properties covered by existing Contracts of Purchase, subject to applicable restrictions of the Federal Tax Code. A Contract of Purchase creates an installment land sale contract between the Department and the veteran which is somewhat analogous to a loan from the Department to the veteran. The amount which the Department finances is reflected in the Contract of Purchase as the "purchase price." See "THE PROGRAM – Contracts of Purchase" in this APPENDIX B.

At present under the Veterans Code, the maximum purchase price to the Department of an existing home or the sum to be expended by the Department pursuant to a Contract of Purchase for a home to be constructed shall not exceed the current maximum Fannie Mae loan limit for a single-family home that is annually set by Fannie Mae (\$359,650 as of January 1, 2005) and for farms is 150% of such Fannie Mae limit (except that the limitation with respect to mobile homes located on or to be located on a leased or rented site in a mobile home park is \$125,000 and except that the maximum purchase price for any home may be increased by an additional \$5,000 for certain purposes). The Legislature has periodically made changes in the maximum amount that may be financed under a Contract of Purchase. The Federal Tax Code imposes maximum purchase prices on properties which are the subject of Contracts of Purchase financed by Qualified Mortgage Bond Proceeds. The Federal Tax Code permits such maximums to be adjusted periodically. (No Federal Tax Code purchase price limits apply to Contracts of Purchase financed from Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds.) These Federal Tax Code requirements vary depending upon where the property is located, if it is in a targeted or non-targeted area, and whether it is a new or existing home. The maximum purchase price under the Program is, therefore, the Veterans Code maximum amount or, if the Contract of Purchase is being financed by Qualified Mortgage Bond Proceeds, the lesser of the Veterans Code maximum amount or the maximum amount under applicable provisions of the Federal Tax Code.

Although the Veterans Code does not impose maximum income limits, the Federal Tax Code imposes maximum income limits applicable only to veterans obtaining Contracts of Purchase financed by Qualified Mortgage Bond Proceeds. The income limits vary by statistical area and family size. No maximum income limits apply to veterans obtaining Contracts of Purchase financed by Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds.



Any veteran who qualifies under the Veterans Code and the Federal Tax Code may be granted a subsequent Contract of Purchase so long as any previous Contract of Purchase has been paid in full or the veteran lost his interest in the previous Contract of Purchase through divorce or dissolution of marriage.

### **Contracts of Purchase**

*General.* Pursuant to the Program, the Department and the veteran enter into a Contract of Purchase for a farm, home or mobile home. Under a Contract of Purchase, the veteran has the benefits of ownership as the equitable owner, but title to the property and improvements is held by the Department as the legal owner until the final principal payment is made. Property sold under a Contract of Purchase may not be transferred, assigned, encumbered, leased, let or sublet without the written consent of the Department. Any permitted encumbrance must be junior or secondary to the Department's interest in the property.

Before 1998, Contracts of Purchase were not insured or guaranteed by the Federal Housing Administration, the United States Department of Veterans Affairs (the "USDVA"), Rural Development (formerly, Farmers' Home Administration), or any private primary mortgage insurer. In 1998, the Department was approved by the USDVA as an originator of loans eligible to receive a guaranty from the USDVA. In addition to the USDVA guaranty, the Department has secured primary mortgage insurance for certain prior and all future Contracts of Purchase not guaranteed by the USDVA with loan-to-value ratios ("LTV") above 80% from Radian Guaranty Inc. ("Radian"). See "THE PROGRAM – Loan Insurance – Primary Mortgage Insurance." Certain Contracts of Purchase are not the subject of loan insurance or guarantees. See APPENDIX C – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase."

The terms of the Contracts of Purchase are substantially identical, except for interest rates on Contracts of Purchase originated after January 1, 1999, regardless of whether they are funded by Unrestricted Moneys, Qualified Veterans Mortgage Bond Proceeds or Qualified Mortgage Bond Proceeds, except for Federal Tax Code-mandated differences in Contracts of Purchase financed with Qualified Mortgage Bond Proceeds. Two ways in which such Contracts of Purchase are different are: (a) Contracts of Purchase financed by Qualified Mortgage Bond Proceeds have more restrictions on the right of a purchaser to assume the obligations under the Contract of Purchase than do Contracts of Purchase financed by Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds and (b) certain Contracts of Purchase financed by Qualified Mortgage Bond Proceeds are subject to Federal Tax Code-mandated recapture provisions. In addition, the Federal Tax Code contains the QMB Loan Eligibility Requirements, which are numerous loan eligibility restrictions on borrowers receiving financing from proceeds such as Qualified Mortgage Bond Proceeds. These restrictions require, among other things, and subject to certain exceptions contained in the Federal Tax Code, that borrowers (i) not have had a present ownership interest in their principal residence during the three-year period preceding the date of financing, (ii) are eligible to finance the purchase of residences with purchase prices not in excess of limits stated in the Federal Tax Code, (iii) must not have family incomes in excess of limits stated in the Federal Tax Code, (iv) may not use the proceeds of the financing to refinance an existing mortgage loan and (v) may use the proceeds of the financing only to finance one-family or one-to-four family dwelling units meeting certain criteria. The Federal

Tax Code includes certain procedures that an issuer of Qualified Mortgage Bonds may undertake to satisfy these requirements, but requires that 95% or more of the proceeds of the bond issue be used in full compliance with the loan eligibility restrictions.

Since the number and aggregate principal balance of Contracts of Purchase relating to farms and mobile homes, and Contracts of Purchase financed pursuant to the 1943 Act, are statistically insignificant, the discussion below is limited to Contracts of Purchase financed under the 1974 Act for homes, excluding farms and mobile homes in rental parks, unless otherwise indicated. See APPENDIX C – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase.”

Many factors affect the ability or willingness of homebuyers to make mortgage loan payments and of potential homebuyers to borrow money to purchase homes. These factors include, among others, general economic conditions, interest rates, and costs of living.

*Origination.* The Veterans Code, in certain cases, requires the veteran to make an initial payment of at least 2% of either the purchase price or the market value of the property, whichever is less. See “— Recent Legislative Changes to the Program” below. In the case of veterans who are ineligible for a full USDVA guaranty, Department policy requires the veteran to make an initial payment of 3% of either the purchase price or the market value of the property, whichever is less. The balance of the purchase price, including USDVA guaranty fees, may be amortized over a period fixed by the Department, not exceeding 30 years and 32 days for all Contracts of Purchase guaranteed by USDVA, and 40 years for any other Contracts of Purchase. Pursuant to its policy, the Department issues all new Contracts of Purchase, except for Contracts of Purchase for mobile homes, for terms of 30 years unless a shorter term is requested. Existing contracts are occasionally extended beyond 30 years in cases of extreme financial hardship.

In addition to the initial payment, if any, referred to in the prior paragraph, a Loan Origination Fee (“LOF”) of 1% of the loan amount is collected at close of escrow on all contracts issued after January 1, 1999. This fee must be paid in escrow by the buyer or seller. If the loan application is submitted through an approved mortgage broker, the 1% fee is paid directly to the mortgage broker through the escrow. Otherwise, the fee is retained by the Department. Contracts of Purchase are originated by the Department’s field offices and mortgage brokers. After a preliminary screening in the field offices, applications will be forwarded to a centralized underwriting unit in Sacramento for processing. The field offices handle overflow loan processing from Sacramento and handle all processing for home improvement loans and construction loans. The mortgage brokers deal directly with the office that is processing the loan. An appraisal fee of \$350 to \$450 is collected by the Department from the applicant and is paid directly to the appraiser by the Department upon completion of the assignment. In rare cases, where the appraisal is performed by a Department employee, the fee is retained by the Department.

*Home Improvement Loans.* The Veterans Code permits the Department to finance permanent home and property improvements. Under the current home improvement loan program, when a home improvement loan is approved, total financing, including the balance of the original loan, the amount of the improvement loan, and any other encumbrances, cannot exceed 90% of the improved market value of the property. Typically this total LTV is much

lower than 90%. Except in the case of hardship, improvement loans are not approved for veterans who have had significant delinquencies in the 12 months immediately preceding the application. Funds are either disbursed by the Department directly to the contractors (or vendors) as the improvements are completed or veterans, who are licensed contractors, can be reimbursed for construction costs. For a home improvement loan subordinate to an existing Contract of Purchase, a separate Contract of Purchase covering only the improvements is executed, bearing interest at the same rate as the veteran's existing Contract of Purchase on home improvement loans made prior to January 1, 2005, or at current Department rates on home improvement loans made after January 1, 2005. The new Contract of Purchase is payable over a term up to 15 years based on the amount of the Contract of Purchase. In no event can the term, from the inception of the original Contract of Purchase through the pay-off of the improvement Contract of Purchase, exceed 40 years. A LOF of 1.5% of the improvement Contract of Purchase amount is charged. The maximum home improvement loan for veterans funded with Qualified Mortgage Bond Proceeds is \$15,000 over the term of the original Contract of Purchase. Home improvement loans funded with Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds are available up to a maximum of \$50,000. Subsequent home improvement Contracts of Purchase may be granted, if funds are available, so long as there is only one home improvement Contract of Purchase to any veteran outstanding at any time. Currently, less than one percent of the total principal balance of all Contracts of Purchase is derived from home improvement loans.

Contracts of Purchase for the purchase of a building site and construction of a home are available. Qualifying sites include undeveloped sites/acreage, lots in subdivision developments, and sites in non-profit self help developments. Mobile homes in parks do not qualify. Construction of the improvements must be performed by a licensed California contractor. The Department does not submit Contracts of Purchase which finance home construction for USDVA guaranty.

The Department also limits availability of financing to veterans on the basis of their personal credit status. Where applicable, the Department's current lending criteria conform to those of the USDVA for participation in the USDVA guaranty program. Department procedures are consistent with those established by USDVA for its loan guaranty program. The Department uses a standard set of underwriting criteria for all of its loans, but those loans with USDVA guarantees have certain additional documentation requirements which conforms with USDVA underwriting criteria.

*Recent Legislative Changes to the Program.* Effective January 1, 2004, the Veterans Code permits veterans eligible for a full USDVA guaranty, subject to the Department's underwriting criteria, to qualify for a loan requiring no down payment. Effective January 1, 2004 the Veterans Code permits the Department to finance permanent home and property improvements for veterans with no existing financing or subordinate to existing financing (provided by lenders other than the Department) through the use of a deed of trust as the financing instrument. The Department has not yet implemented a program to fund loans subordinate to existing debt.

The history of the Department's originations of Contracts of Purchase is set forth in APPENDIX C – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND

OPERATING DATA – Contracts of Purchase – Contracts of Purchase Origination and Principal Repayment Experience.”

*Servicing.* All Contracts of Purchase are serviced by the Department. Late penalty charges are applied to Contracts of Purchase that have a remaining amount due of \$25 or more at the close of any account month. A \$10 late penalty charge is imposed on Contracts of Purchase originated before October 1984. Contracts of Purchase originated during and after October 1984 are subject to a late penalty charge of 4% of the principal and interest portion of the installment, consistent with penalties authorized by USDVA.

The Department may, in any individual case and for good cause, permit the postponement from time to time, and upon such terms as it deems proper, of the payment of the whole or any part of any installment. Contracts of Purchase may also have terms in excess of 30 years if home improvement loans have been obtained, as discussed above, or under certain hardship conditions. The terms of Contracts of Purchase guaranteed by USDVA, however, cannot exceed 30 years and 32 days, unless the USDVA, in its sole discretion, approves such extension.

*Prepayment Penalties.* There are no prepayment penalties on any Contracts of Purchase. The Department’s actual past prepayment experience for existing Contracts of Purchase is set forth in APPENDIX C – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Contracts of Purchase Origination and Principal Repayment Experience.”

*Cancellations and Delinquencies.* The Department’s policies regarding delinquencies and cancellations conform to USDVA loan guaranty program requirements and the requirements of Radian. In the event of a failure to comply with any of the terms of a Contract of Purchase, the Department may cancel the Contract of Purchase and be released from all obligations, at law or in equity, to convey the property. In such event, the veteran’s rights under the Contract of Purchase may be forfeited and all payments made by the veteran prior to termination of the Contract of Purchase deemed to be rental paid for occupancy. Upon such forfeiture, the Department takes possession of the property covered by the Contract of Purchase and resells it.

If a veteran does not make a payment by the 16<sup>th</sup> day of the month in which the payment is due, the payment is considered “delinquent.” The mortgage finance system (Mitas) generates a reminder letter automatically if payment is not received by the 20<sup>th</sup> day of the month, which advises the veteran that the account is delinquent. If payment is not received by the 30<sup>th</sup> day of the month, a second reminder letter is issued. If the account remains delinquent 60 days, a Notice of Intent to Cancel Contract (“NICC”) is issued giving notice that the Contract of Purchase may be canceled at the end of the 30-day notice period unless the account is brought current. Department personnel then initiate telephone contact with veterans with delinquent accounts. If the veteran has not paid by the 70<sup>th</sup> day of the delinquency, a letter is issued reminding the veteran that he or she must bring the account current within 30 days of the NICC date. A schedule for liquidation of delinquent payments satisfactory to the Department is arranged during this period; however, if the account remains delinquent after such 30-day period and no schedule for liquidation of delinquent payments has been agreed upon, the Department may begin cancellation of the Contract of Purchase. If a schedule of liquidation has been agreed

to with respect to a Contract of Purchase and the veteran makes all regularly scheduled payments and liquidation payments on a timely basis, the Department does not begin cancellation of the Contract of Purchase.

The Department's headquarters Collections Unit monitors the delinquency throughout this process, orders a title search to identify any junior lienholders and forwards the pertinent information to the Department's Foreclosure and REO Unit for further precancellation processing in accordance with the California Code of Regulations, Title 12, Section 344, Military and Veterans Affairs. Junior lienholders are identified and sent notices giving them 30 days (40 days in the case of Federal tax liens) to protect their interest by beginning foreclosure proceedings. If the account is not brought current during such notice period to junior lienholders and no junior lienholder proceeds with a foreclosure action to protect its interest, the Department's Foreclosure Unit cancels the contract, and a Notice of Cancellation is mailed to the veteran and recorded. The Department's Foreclosure Unit then takes steps to evict occupants and clear any remaining liens. If judicial action is required, the case is referred to the Department's Law Division for additional processing.

After all remaining liens are removed and the property is vacant, the repossessed property is repaired and improved, if necessary and feasible, and is marketed through the Department's centralized repossession sales unit (Foreclosure and REO Unit) through a Pre-Advertising Listing ("PAL") program. The PAL program involves listing a property for sale with a licensed real estate broker or agent, at an overall commission rate which typically does not exceed 6%. The Department is required to advertise and accept sealed offers during a 2-week period, and the property is sold to the highest acceptable bidder (best net return). If no acceptable bids are received, the property will continue to be marketed by the listing real estate agent until an acceptable offer is received and the property is sold.

Federal law provides certain protections to military personnel on active duty or reservists ordered to report for military service under The Soldiers' and Sailors' Civil Relief Act of 1940, as amended (the "Soldier's and Sailor's Relief Act"). Under the Soldier's and Sailor's Relief Act, the veteran may seek a stay (or a court may on its own motion grant a stay) of any court action or proceeding. The Department conducted a voluntary survey by mail in 2003 of all holders of Contracts of Purchase. Approximately 375 holders of Contracts of Purchase indicated that they were members of the National Guard or the Reserves subject to being called to active duty. To date, there has been no material impact on the 1943 Fund.

See APPENDIX C – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – CONTRACTS OF PURCHASE – Cancellations and Delinquencies" for additional information regarding the status of Contracts of Purchase.

*Interest Rates.* Contracts of Purchase originated prior to January 1, 1999 bear interest at a rate which is set by the Department and may be changed with the approval of the Board and the Veterans' Finance Committee of 1943 (the "Finance Committee"). Most Contracts of Purchase originated prior to January 1, 1999 currently bear interest at a rate of 6.95%. The Veterans Code currently requires that, generally, all Contracts of Purchase originated prior to January 1, 1999 (the "pre-1999 Contracts of Purchase") bear the same interest rate. In accordance with the current provisions of the Veterans Code, the interest rate for such pre-1999 Contracts of

Purchase can be changed annually as deemed necessary. The effective date of a higher rate of interest on pre-1999 Contracts of Purchase may occur only once in any calendar year unless a finding is made by the Board and the Finance Committee that such additional action is necessary to protect the solvency of the 1943 Fund.

Legislation passed in 1998 (i) eliminated the uniform interest rate requirement for Contracts of Purchase originated on or after January 1, 1999; (ii) allows the Department to establish non-uniform fixed or variable interest rates for such Contracts of Purchase; and (iii) allows the Department to modify such interest rates, or the methodology and timing for determining or modifying interest rates, from time to time, subject to the approval of the Board and the Finance Committee. The Department received approval to implement a flexible mechanism to provide for periodic adjustments of the interest rate on new Contracts of Purchase funded from Qualified Mortgage Bond Proceeds, Qualified Veterans Mortgage Bond Proceeds, and Unrestricted Moneys. As a result of such mechanism, interest rates for new Contracts of Purchase funded on and after April 4, 2005 are currently 5.50% for Contracts of Purchase financed using Qualified Mortgage Bond Proceeds, 5.15% for Contracts of Purchase financed using Qualified Veterans Mortgage Bond Proceeds, and 5.50% for Contracts of Purchase using Unrestricted Moneys. Interest rates on Contracts of Purchase are expected to be established in the future based on various factors deemed appropriate by the Department, subject in all cases to the requirements of the resolution authorizing the issuance of Revenue Bonds (the "Revenue Bond Resolution") for the filing of Cash Flow Statements and conformance with Program Operating Procedures. As noted herein, the Program Operating Procedures are operating policies of the Department governing the discretionary activities of the Department under the Revenue Bond Resolution. The Cash Flow Statement consists of the conclusion by an authorized representative of the Department that projected revenues will be sufficient to provide for timely payment of principal of and interest on the Revenue Bonds and expenses, under each scenario included in the quantitative analysis which accompanies the Cash Flow Statement. See APPENDIX C – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – CONTRACTS OF PURCHASE – Selected Principal Flows with respect to Contracts of Purchase funded by both Veterans G.O. Bonds and Revenue Bonds."

The Soldiers' and Sailors' Relief Act provides that if a veteran obtained a Contract of Purchase and is later recalled to active duty, then during the period of military service the interest rate on the Contract of Purchase cannot exceed 6% (unless the ability of the veteran to pay interest in excess of 6% is not materially impaired by such military service). Accordingly, the effect of any application of The Soldiers' and Sailors' Relief Act in most cases would be a reduction in the applicable interest rate of less than one percent or no reduction at all.

### **Loan Insurance**

Since 1997, the Department has completed several programmatic changes, including obtaining loan insurance from a private primary mortgage insurer for certain existing Contracts of Purchase with high LTVs, and USDVA guarantees or private primary mortgage insurance for all new Contracts of Purchase (except mobile homes in parks, construction loans during the construction period, and home improvement loans) with LTVs above 80% up to 100%. In addition to the LOF and initial payment, the Department collects a funding fee of from 1.25% up to 3.3% of the Contract of Purchase amount, based on the LTV for each Contract of Purchase

which exceeds an LTV of 80%. For USDVA guaranteed loans, the funding fee may be added to the purchase price. On Radian guaranteed loans, the maximum loan amount is 97% so the funding fee cannot be added to the loan unless the downpayment is increased so that the total loan amount, including the funding fee, does not exceed 97%. Veterans described above who are ineligible for a full USDVA guaranty and therefore are obligated to make an initial 3% payment must advance a funding fee of up to 2% of the base loan amount to the Department at close of escrow, and the funding fee may not be added to the base loan amount. With respect to eligible Contracts of Purchase, this fee is paid to the USDVA for the cost of the loan guaranty. If the veteran or the property is not eligible for a USDVA loan guaranty, the funding fee is retained by the Department, and a portion of such funding fees is used by the Department to pay costs related to the Radian primary mortgage insurance. Any change to the foregoing insurance and guaranty expectations could require an amendment to the Department's Program Operating Procedures and delivery of a new Cash Flow Statement. A significant principal amount of Contracts of Purchase are not covered by loan insurance. See Exhibit 2 to this APPENDIX B - "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA - Contracts of Purchase - Existing Contracts of Purchase - Current Loan-to-Value Ratio of Contracts of Purchase."

*Primary Mortgage Insurance.* The Department purchased from Radian a policy of primary mortgage insurance for a pool of certain prior Contracts of Purchase with LTVs above 80%. The insurance financial strength of Radian is rated "AA" by S&P, "Aa3" by Moody's and "AA" by Fitch. Such ratings reflect only the view of the respective rating agencies and an explanation of the significance of such ratings may be obtained from the respective rating agencies. There is no assurance that the ratings will continue for any given period of time or that they will not be revised or withdrawn entirely by such ratings agencies if, in their judgment, circumstances so warrant. This Radian policy provides coverage on such pool back to February 1, 1998. The Department has purchased an additional policy of primary mortgage insurance from Radian which provides the same coverage as provided in the original policy, except that the Department now includes certain existing and all new Contracts of Purchase with 97% to 100% LTV ratios that are not qualified for USDVA guarantees (except mobile homes in parks, construction loans and home improvement loans, all of which continue to be covered by the Department). Under this second policy, Radian has committed to insure Contracts of Purchase originated by the Department after January 1, 2000 until the aggregate principal amount of Contracts of Purchase insured under the second policy reaches \$1.6 billion. Each of the Radian policies provides for coverage for aggregate losses incurred on Contracts of Purchase following property disposition, above an aggregate 2% deductible based upon a percentage of the originally insured balances of the Contracts of Purchase of the applicable pool. Under both Radian policies, once the applicable aggregate deductible has been reached, insurance claims may be made based upon the individual LTV of the particular defaulted Contract of Purchase, as set forth below. For these purposes, LTV is calculated using the original appraised value of the property.

**Radian Mortgage Insurance Coverage Ratios Subject to a  
Deductible of 2% of the Originally Insured Balances of the  
Contracts of Purchase in the Applicable Insured Pool**

<u>LTV Category</u>	<u>% of Coverage</u>
97.01% to 100.00%	35%
95.01% to 97.00%	35%
90.01% to 95.00%	30%
85.01% to 90.00%	25%
80.01% to 85.00%	17%

For information regarding the principal amount of Contracts of Purchase covered by the Radian policies, see APPENDIX C – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase - Current Loan-to-Value Ratio of Contracts of Purchase.”

*USDVA Guaranty Program.* The Department was approved by the USDVA as a “supervised lender with automatic processing authority” as of March 10, 1998. On July 27, 1998, the Department received USDVA approval under the Lender Appraisal Processing Program (“LAPP”) to process appraisals and determine reasonable value without prior USDVA review. The Department seeks USDVA loan guarantees for all Contracts of Purchase with a LTV of 80% or higher, unless the Contract of Purchase is not eligible for USDVA guaranty. Contracts of Purchase not eligible for guaranty are primarily contracts with veterans who have previously used their USDVA guaranty eligibility and do not qualify for reinstatement, contracts for the purchase of new homes not inspected by USDVA during construction and contracts where the purchase price exceeds USDVA limits. Also, a very small number of veterans have service that meets Veterans Code eligibility requirements but does not meet USDVA eligibility requirements.

The Servicemen’s Readjustment Act of 1944, as amended, permits a veteran (or in certain instances the veteran’s spouse) to obtain a mortgage loan guaranty from USDVA covering mortgage financing of the purchase or construction of a one-to-four family dwelling unit at interest rates permitted by USDVA. The USDVA program has no preset mortgage loan limits and permits the guaranty of mortgage loans of up to 30 years and 32 days’ duration unless the USDVA, in its sole discretion, approves an extension. Under the USDVA program, the maximum USDVA guaranty on a loan is an amount equal to 25% of the Freddie Mac conforming loan limit for a single family residence. The 2005 Freddie Mac conforming loan limit for a single family residence for 2005 is \$359,650. The liability on the guaranty is reduced or increased *pro rata* with any reduction or increase in the amount of indebtedness, but in no event will the amount payable on the guaranty exceed the amount of the original guaranty. Notwithstanding the dollar and per centum limitations of the guaranty, a mortgage holder will ordinarily suffer a monetary loss only where the difference between the unsatisfied indebtedness and the proceeds of a foreclosure sale of a mortgaged property is greater than the original guaranty as adjusted. Periods without interest payments prior to foreclosure will also increase the potential for losses. In the event of a default in the payment of a USDVA loan, but prior to a suit or foreclosure, USDVA may, at its option, pay to a mortgage holder the unpaid balance of the obligation plus accrued interest and receive an assignment of the loan and security. For



information regarding the amount of Contracts of Purchase guaranteed by the USDVA, see APPENDIX C – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase - Current Loan-to-Value Ratio of Contracts of Purchase.”

### **Property and Life and Disability Insurance**

The Veterans Code and/or long-standing Department policy have called for the veteran contract-holder to maintain certain insurance with respect to the property covered by a Contract of Purchase. Insurance must be in the amount and under the conditions specified by the Department, and is either provided by the Department or by insurance companies selected by the Department. Any change to the insurance requirements could require amending the Department's Program Operating Procedures.

*Fire and Hazard Coverage.* The Department self-insures for fire and hazard losses, using the 1943 Fund to make payments to veterans, up to a Department deductible. The Master Policy described below (the “Master Policy”) provides \$50,000,000 coverage in excess of the Department deductible, except that the Master Policy does not cover mobile homes, condominiums or planned unit development properties covered by blanket insurance policies provided by homeowners' associations. The Department contracted with Marsh Risk and Insurance Services to conduct a Conflagration Exposure Analysis. The analysis concluded that the probable maximum exposure risk to the properties insured under the Program from a major event, or conflagration, would not exceed \$20,000,000, which is the first layer of coverage of the Master Policy, in excess of the Department's \$2,500,000 per occurrence and \$13,000,000 annual aggregate deductibles. Therefore, the total coverage in excess of the Department deductible was reduced from \$100,000,000 to \$50,000,000 for the policy year beginning October 31, 2003. The Master Policy is provided by commercial insurers (the “Provider”). The lead insurer for the Provider is Allianz Global Risks U.S. Insurance Company.

Under each Contract of Purchase, the veteran is required to pay the sum charged to his or her account to cover costs of providing the insurance coverage including the insurance premium due under the Master Policy with respect to his or her property. From the amount charged to each veteran, the Department retains a portion to provide the sums necessary to pay all losses up to the Department deductible, which is \$2,500,000 per occurrence or \$13,000,000 per policy year. If the total losses from a single occurrence exceed \$2,500,000 or if the aggregate of all fire and hazard insurance losses for a policy year exceed \$13,000,000, liability for the excess will be covered under the Master Policy. The coverage under the Master Policy extends to October 31, 2005. The Master Policy is an all-physical loss form.

Fire and hazard insurance coverage for participants in the Program is adjusted annually to reflect increasing building costs and is maintained on a guaranteed replacement cost basis for homes and on an actual cash value basis for outbuildings. A \$250 deductible payable by the veteran applies to each loss. Claims must be submitted within 12 months of loss. Each veteran with a Contract of Purchase pays an annual insurance premium equal to \$0.22 per \$100 of insured value which is prorated and included in the veteran's monthly installment. Claims adjustments and payments are made on behalf of the Department and the provider of the Master Policy by an affiliate of such provider.

The Department anticipates that the dollar amount of claims resulting from the major wildfires in Southern California in October and November 2003, combined with other claims, will not exceed the \$13,000,000 annual aggregate deductible under the Master Policy. This is consistent with the results of the Conflagration Exposure Analysis.

*Disaster Indemnity Plan.* The Department provides certain disaster indemnity and catastrophe real property insurance (“Disaster Indemnity Plan”). Neither such insurance nor the indemnity fund described below are payable from or a part of the 1943 Fund. The Disaster Indemnity Plan indemnifies participants against the cost of repairing damage in excess of a deductible caused by flood or earthquake. The deductible for flood losses is \$500 and the deductible for earthquake losses is \$500 or 5% of the amount of loss, whichever is higher. The catastrophe insurance has been obtained from a consortium of ten insurance companies for a total of \$50,000,000 of coverage with a \$4,000,000 deductible per occurrence and in the aggregate annually. Once such deductible has been exceeded, subsequent occurrences are subject to a \$100,000 per occurrence deductible. The 2004 – 2005 one-year premium for this coverage is \$3,582,500.

Each veteran in the Program participates in the Disaster Indemnity Plan and pays his or her *pro rata* share of the annual premium. Such payments are deposited in an indemnity fund created in the Treasury of the State to be utilized to pay the deductible discussed above. Each veteran pays an initial assessment of \$.80 per \$1,000 of insured value, and any assessments as may be required to sustain the indemnity fund. The value of the indemnity fund as of June 30, 2004 was \$14,879,000.

Effective December 1, 1997, the Department purchases individual flood policies through the Federal Emergency Management Agency (“FEMA”) covering all properties financed by Contracts of Purchase that are located in designated flood zones. Coverage under this policy is renewable annually.

*Life and Disability Coverage.* In the past, the Department self-insured from the 1943 Fund life and disability coverage for veterans with Contracts of Purchase. Following a period of significant and recurring losses incurred by the 1943 Fund, the Department, effective June 1, 1996, replaced most of the Department’s self-insured life and disability insurance program with an interim life and disability insurance plan (the “Life and Disability Plan”) provided by Pacific Life and Annuity Company (“Pacific Life”) (previously PM Group Life Insurance Company). Effective February 1, 1998, after a competitive bidding process, the interim plan was replaced with a long-term life insurance and disability plan, also provided by Pacific Life. Effective February 1, 2003, after another competitive bidding process, the Pacific Life plan was replaced by a three-to-five-year life insurance and disability plan, provided by the Standard Insurance Company. The Department continues to self-insure those veterans who were already receiving disability benefits at the time the Life and Disability Plan was implemented, with benefits equal to the amount of the monthly Contract of Purchase payment at the time of their disability. Those benefits will continue under the provisions of the self-insured plan until the beneficiary returns to active employment or dies, or his or her contract is paid off. Loss reserves for these obligations are actuarially based. The Department holds funds in the 1943 Fund to pay all benefits under the self-insured plan. See “THE 1943 FUND – Selected Financial Data of the 1943 Fund and Department’s Discussion” in this APPENDIX B.

As noted above, effective February 1, 2003, the Department implemented a new life and disability protection plan, which is provided by the Standard Insurance Company. All holders of Contracts of Purchase who had life and disability coverage (exclusive of those receiving self insured benefits described above) under the prior plan were transferred automatically to the new plan. Major elements of the life and disability coverage, include, for life insurance a five-year principal and interest benefit under the mandatory life coverage. Disability coverage has a 90-day waiting period with a maximum 24-month benefit, unless the injury was the cause of an accident, which would allow for a maximum 60-month benefit. These benefits continue to age 62 for disability and age 70 for life benefits. The goal of the Department in going to bid for a new insurance provider was to improve disability benefits while maintaining the financial integrity of the Program. The new plan reduced the administrative charges for both the insured and self-insured programs, and increased disability benefits, with no increase in premiums.

The new insured life insurance program offers the same five-year rate guarantee on an insurance rated policy. The new insured disability program has three benefit options. Option 1 has a 90-day waiting period, two-year sickness or five-year accident benefit and five years after termination of the two-year sickness or five-year accident benefit, the claimant can qualify for the life of loan benefit if they are unable to perform two so-called Activities of Daily Living, at no additional cost to the claimant. Option 2 also has a 90-day waiting period, but with a premium that is 1.7 times higher than standard and the claimant will receive life of the loan coverage. Option 3 has a one-year waiting period, with life of the loan coverage at no additional premium.

## **SUMMARY OF CERTAIN PROVISIONS OF THE RESOLUTION**

The following is a summary of certain provisions of the Resolution. **This summary does not purport to be comprehensive and reference should be made to the Resolution for a full and complete statement of its provisions.**

### **Resolution to Constitute Contract (Section 101)**

In consideration of the purchase and acceptance of any and all of the Bonds issued under the Resolution by those who shall own the same from time to time, the Resolution shall be deemed to be and shall constitute a contract between the Department, the Trustee and the owners of the Bonds, and the pledges made in the Resolution and the covenants and agreements in the Resolution set forth to be performed by the Department or the Trustee shall be for the equal benefit, protection and security of the owners of any and all of the Bonds, all of which, without regard to the time or times of their issue or maturity, shall be of equal rank without preference, priority or distinction of any of the Bonds over any other of the Resolution, except as expressly provided in or permitted by the Resolution or by the applicable Series Resolution.

### **Pledge Effected by the Resolution (Section 102)**

For the purpose of fixing and declaring the terms and conditions upon which the Bonds are to be issued, executed, delivered, secured and accepted by the owners of the Bonds, and in order to secure the payment of all Bonds at any time issued and Outstanding under the Resolution and the interest thereon according to their tenor, purport and effect, and in order to

secure the performance and observance of all the covenants, agreements and conditions therein and in the Resolution contained, the Department has adopted the Resolution, has pledged, conveyed and assigned, and, subject to the subordination provisions in favor of other debt holders of the Department contained in the definition in the Resolution of Pledged Property, does by the Resolution pledge, convey and assign the Pledged Property to the Trustee as security for the payment of the principal of, including redemption premium, if any, on the Bonds and the interest thereon for the equal and proportionate benefit and security, from time to time, of the owners of the Bonds, without preference, priority or distinction as to lien or otherwise, *except* as otherwise provided in the Resolution or as provided in an applicable Series Resolution, of any one Bond over any other Bond, by reason of priority in the issue, sale or negotiation thereof or otherwise, all in accordance with the terms of the Resolution.

### **Definitions (Section 103)**

In the Resolution and any resolution supplemental to the Resolution the following terms shall have the following meanings:

“Account” means an Account (and any subaccounts therein) created by or pursuant to the Resolution or a Series Resolution.

“Accountant” means an independent certified public accountant or firm of independent certified public accountants selected by the Department, who may be the accountant or firm of accountants who regularly audit the books of the Department.

“Accrued Debt Service” means, as of any date of determination and, as the context of the Resolution requires, with respect to all Bonds and/or all Veterans G.O. Bonds, the sum of:

(a) the aggregate amount of scheduled interest and principal (except to the extent principal is otherwise to be redeemed pursuant to clause (b) or (c) hereof) to become due after such date but on or before the end of the current Debt Service Year, less the product of (i) the number of whole months remaining in the current Debt Service Year and (ii) the Monthly Debt Service Requirement;

(b) the redemption price of bonds for which notice of redemption has been issued, provided such redemption price is to be paid from amounts on deposit in the Revenue Account; and

(c) the redemption price of bonds that the Department will be obligated to redeem prior to the end of the next succeeding Debt Service Year under the terms of any Series Resolution or Supplemental Resolution or resolution of issuance governing Veterans G.O. Bonds, to the extent that such obligation arises on account of amounts on deposit in the Revenue Account.

“Additional Bonds” means any additional Bonds issued pursuant to Section 209 of the Resolution.

“Amortized Value” means the purchase price of securities, excluding accrued interest, plus an amortization of any discount or less an amortization of any premium included in the

purchase price. The premium or discount shall be amortized on an actuarial basis, such that the Amortized Value at any time equals the price at which the yield on a security equals the yield of such security as of its original purchase. In the case of an Investment Obligation callable at the option of the issuer thereof, the original yield and Amortized Value shall be computed on the assumption that, (i) for securities purchased at a premium, such security is redeemed as of the first possible redemption date, provided, that after such redemption date, such value of the Investment Security shall be computed at par; or (ii) for securities purchased at a discount, such security is held to maturity.

“Applicable Fund Parity Percentage” means 50% or such other percentage set forth in the Program Operating Procedures. But see “SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS – Maintenance of Fund Parity” for current percentage.

“Appreciated Amount” means, with respect to a Deferred Interest Bond, (i) as of any date of computation with respect to any Deferred Interest Bond up to the date, if any, set forth in the Series Resolution authorizing such Deferred Interest Bond as the date on which such Deferred Interest Bond shall commence to bear interest payable thereafter on applicable interest payment dates, an amount equal to the initial principal amount of such Deferred Interest Bond plus the interest accrued on such Deferred Interest Bond from the date of original issuance of such Deferred Interest Bond to the applicable interest payment date next preceding the date of computation or the date of computation if an applicable interest payment date, such increased amount to accrue at the rate per annum set forth in the Series Resolution authorizing such Deferred Interest Bond, compounded on each applicable interest payment date, plus, if such date of computation shall not be an applicable interest payment date, a portion of the difference between the Appreciated Amount as of the immediately preceding applicable interest payment date (or the date of original issuance if the date of computation is prior to the first applicable interest payment date succeeding the date of original issuance) and the Appreciated Amount as of the immediately succeeding applicable interest payment date, calculated based upon an assumption that the Appreciated Amount accrues in equal daily amounts on the basis set forth in the Series Resolution authorizing such Deferred Interest Bonds; and (ii) as of any date of computation on and after the date, if any, set forth in the Series Resolution authorizing such Deferred Interest Bond as the date on which such Deferred Interest Bond shall commence to bear interest payable thereafter on applicable interest payment dates, the Appreciated Amount as of such current interest payment commencement date.

“Authorized Representative” or “Authorized Officer” means the Secretary of Veterans Affairs, Undersecretary of Veterans Affairs, Deputy Secretary of Operations, Deputy Secretary of Administration or any other authorized representative as from time to time may be designated by the Secretary in writing to the Trustee as authorized to act under the Resolution on behalf of the Department.

“Bond Act” means the Veterans’ Revenue Debenture Act of 1970 (constituting Chapter 7 of Division 4 of the Veterans Code), as now in effect and as it may from time to time hereafter be amended or supplemented.

“Bond Registrar” means the Trustee as the party responsible for maintenance of the Bond registration books of the Department pursuant to Section 208 of the Resolution.

“Bond Reserve Account” means the Bond Reserve Account established pursuant to Section 401 of the Resolution.

“Bond Reserve Requirement” means, as of any particular date of calculation, an amount equal to the aggregate of all amounts established for all Series of Bonds Outstanding in the Series Resolutions authorizing the issuance of such Bonds, at least equal in the aggregate to three per centum (3%) of the aggregate Outstanding principal amount of the Bonds with interest rates fixed to the maturity thereof.

“Bondowner” or “owner of Bonds” or “Holder” or “Bondholder” means the registered owner of any registered Bond.

“Bonds” means Revenue Bonds.

“Cash Equivalent” means a Letter of Credit, Insurance Policy, Surety, Guarantee or other Security Arrangement (as defined and provided for in a Series Resolution providing for the issuance of Bonds or in a Supplemental Resolution), provided by an institution which has received a rating of its claims paying ability from each of the Rating Agencies at least equal to the then-existing respective rating on the Bonds or whose unsecured debt securities are rated at least the then-existing respective rating on the Bonds (or the highest rating of short-term obligations if the Cash Equivalent is a short-term instrument) by the Rating Agencies.

“Cash Flow Statement” means a Cash Flow Statement conforming to the requirements of Section 607 of the Resolution.

“Certificate of the Department” means an instrument in writing signed by an Authorized Representative.

“Committee” means the Veterans’ Debenture Finance Committee created by the Bond Act.

“Contract of Purchase” means any contract of purchase entered into by the Department and a veteran or other eligible person covering any property (whether residential or otherwise) purchased or acquired by the Department with moneys in the 1943 Fund or any other obligation representing a program investment of such moneys irrespective of the form of such obligation.

“Costs of Issuance” means all items of expense payable or reimbursable directly or indirectly by the Department and related to the authorization, sale, issuance and remarketing of the Bonds, as certified by an Authorized Representative.

“Credit and Liquidity Support Expenses” means, with respect to a Series of Bonds or a series of Veterans G.O. Bonds (as the context requires), as set forth in a Series Resolution or Supplemental Resolution, or resolution of issuance governing such series of Veterans G.O. Bonds, respectively, the amounts necessary to pay any fees and reimbursement in connection with tender option features, letters of credit, standby bond purchase agreements, bond insurance and other forms of credit and liquidity support related thereto.

“Debt Service Year” means the year beginning on the second day of October and ending on the first day of October in the next succeeding year, or any other twelve-month period hereafter selected and designated as such in the Program Operating Procedures.

“Deferred Interest Bond” means any Bond designated as such by the Series Resolution authorizing the issuance of such Bond.

“Department Request” means a written request or direction of the Department signed by an Authorized Representative.

“Excess Revenues” means, as of any date of calculation, the amount of all Revenues held in the Revenue Account in excess of Accrued Debt Service (as adjusted for any use of Revenues contemplated at the time of such calculation).

“Expenses” means any moneys required by the Department to pay, or to be set aside to pay, the expenses of the Trustee and any expenses which the Department may lawfully pay from the 1943 Fund (whether or not related to the Bonds), except (i) as limited with respect to any Series of Bonds by the applicable Series Resolution and (ii) that Credit and Liquidity Support Expenses shall not be included in the definition of “Expenses”; *provided, however*, that such expenses related to Cash Equivalents shall not be excluded.

“Fiscal Year” means the year beginning on the first day of July and ending on the last day of June in the next succeeding year, or any other twelve-month period selected and designated as the official fiscal year period of the Department.

“Fitch” means Fitch IBCA, Inc., and includes any successor thereto.

“Fund Parity” means, on any determination date, (A) an amount equal to the difference between (i) all assets in the 1943 Fund and in the Accounts established under the Resolution and (ii) the aggregate Outstanding principal amount of all Bonds and all Veterans G.O. Bonds (plus accrued interest) reduced by (B) allowances and reserves for loss coverage on Contracts of Purchase, loss coverage on properties subject to Contracts of Purchase, and life and disability coverage on persons obligated under Contracts of Purchase, as specified in the Program Operating Procedures.

“Government Obligations” means bonds or interest-bearing notes or obligations of the United States, or those for which the faith and credit of the United States are pledged for the payment of principal and interest.

“Investment Obligations” means, any of the following which at the time of purchase are legal investments under the laws of the State of California for moneys held under the Resolution and then proposed to be invested therein:

- (1) Government Obligations;
- (2) Bonds, consolidated bonds, collateral trust debentures, consolidated debentures, or other obligations issued by federal land banks or federal intermediate credit banks established under the Federal Farm Loan Act, as amended, debentures and

consolidated debentures issued by the Central Bank for Cooperatives and banks for cooperatives established under the Farm Credit Act of 1933, as amended, bonds or debentures of the Federal Home Loan Banks, stock, bonds, debentures and other obligations of the Government National Mortgage Association or the Federal National Mortgage Association established under the National Housing Act as amended, obligations of the Federal Home Loan Mortgage Corporation, and bonds, notes and other obligations issued by the Tennessee Valley Authority under the Tennessee Valley Authority Act as amended;

(3) interest-bearing demand or time deposits in banks or savings and loan associations, which, to the extent they are not insured by federal deposit insurance, are collateralized by securities eligible to secure public deposits in the State, or which are issued by an institution, the senior unsecured debt of which is rated in one of the top two rating categories of a Rating Agency;

(4) negotiable certificates of deposit issued by a nationally or state-chartered bank or savings and loan association or by a state-licensed branch of a foreign bank which, to the extent they are not insured by federal deposit insurance, are collateralized by securities eligible to secure public deposits in the State, or which are issued by an institution the senior unsecured debt of which is rated in one of the top two rating categories by a Rating Agency;

(5) repurchase agreements backed by or related to obligations described in (1) or (2) above with any institution whose unsecured debt securities are rated, or which agreements are rated, at least equal to the then existing rating on the Bonds (or the highest rating of short-term obligations if the investment is a short-term obligation) by a Rating Agency;

(6) (1) investment agreements, secured (by collateralization, guaranty or otherwise) or unsecured, with any institution, or fully guaranteed by any institution, whose unsecured debt securities are rated at least equal to the then existing rating on the Bonds (or the highest rating of short-term obligations if the investment is a short-term obligation) by a Rating Agency; or (2) any investment agreement that is secured (by collateralization, guaranty or otherwise), to such extent that the investment agreement itself is the subject of such a rating or the Bonds are the subject of written confirmation from a Rating Agency that investment of amounts in such an investment agreement will not cause the outstanding rating of the Bonds by such Rating Agency to be withdrawn, downgraded or suspended;

(7) commercial paper (having original maturities of not more than 180 days) rated in the highest rating category by a Rating Agency;

(8) direct and general obligations of or obligations unconditionally guaranteed by any state or political subdivision thereof, the payment of the principal of and interest on which the full faith and credit of the state or such political subdivision is pledged, and certificates of participation in any such obligations (which obligations may be subject to



annual appropriations), which obligations or certificates of participation, respectively, are rated at least equal to the then existing rating of the Bonds by a Rating Agency;

(9) investments in any mutual fund the portfolio of which is limited to Investment Obligations, including any proprietary mutual fund of the Trustee or co-Trustee for which the Trustee or co-Trustee or an affiliate is investment advisor or provided other services to such mutual fund and receives reasonable compensation for such services (and if such mutual fund consists solely of Government Obligations, then such fund will constitute "Government Obligations" for the purposes of the Resolution);

(10) obligations of any state, political subdivision, political corporation or agency, the payment of principal, redemption price, if any, and interest on which is irrevocably secured by Government Obligations; and

(11) deposits in the Surplus Money Investment Fund in the Treasury of the State.

Provided, that it is expressly understood that the definition of Investment Obligations shall be, and be deemed to be, expanded, or new definitions and related provisions shall be added to the Resolution by a Supplemental Resolution adopted and filed in accordance with Section 1001(j) of the Resolution thus permitting investments with different characteristics from those permitted which the Department deems from time to time to be in the interests of the Department to include as Investment Obligations;

For purposes of the definition, "institution" means an individual, partnership, corporation, trust or unincorporated organization, or a government or agency, instrumentality, program, account, fund, political subdivision or corporation thereof.

If the rating of any Investment Obligation purchased pursuant to the Resolution is downgraded, suspended or withdrawn by any Rating Agency, the Trustee is not required to sell such Investment Obligation but may retain the same under the Resolution.

"Liquidation/Insurance Proceeds" means amounts representing proceeds of (1) the sale or other disposition of any property subject to any Contract of Purchase, whether upon cancellation of said Contract of Purchase (on account of default or any other cause) or for any other cause, exclusive of amounts so recovered and required by law, contract or resolution of the Department to be otherwise applied; and (2) compensation for losses incurred with respect to the property subject to any Contract of Purchase from the proceeds of condemnation, title insurance, hazard insurance, or primary or pool insurance of the Contracts of Purchase (including Veterans Administration guarantees), exclusive of amounts recovered in respect of such losses to the extent required to be otherwise applied pursuant to applicable law, contract or resolution of the Department.

"Loan Loss Account" means the Loan Loss Account established pursuant to Section 401 of the Resolution.

"Loan Loss Requirement" means, as of any particular date of calculation, an amount established in the current Cash Flow Statement which, when added to the Bond Reserve

Requirement, shall not exceed ten percent (10%) of the initial principal amount of all Series of which any Bonds are Outstanding or such larger amount as may be provided in a Supplemental Resolution adopted pursuant to Section 1001(m) of the Resolution.

“Mandatory Sinking Account Payments” means, as of any particular date of calculation, with respect to the Term Bonds of any Series and maturity, the amount of money required to be applied on any applicable date to the redemption prior to maturity or the purchase of the Term Bonds, except as such requirement shall have been previously reduced by the principal amount of any Term Bonds of such Series and maturity with respect to which such Mandatory Sinking Account Payments are payable which are to be purchased or redeemed (except out of Mandatory Sinking Account Payments). Mandatory Sinking Account Payments may be established as fixed dollar amounts or as method(s) of calculation thereof.

“Monthly Debt Service Requirement” means, as of any date of determination, one-twelfth (1/12) of the aggregate amount of scheduled interest and principal to become due during the Debt Service Year in which such date falls, as computed on the first day of such Debt Service Year.

“Moody’s” means Moody’s Investors Service, Inc., and includes any successor thereto.

“1943 Fund” means the Veterans’ Farm and Home Building Fund of 1943, established in the Treasury of the State by Section 988 of the Veterans Code.

“Outstanding” as used in relation to Bonds means, as of any date, all Bonds theretofore authenticated and delivered by the Trustee under the Resolution, except:

- (a) any Bond deemed paid in accordance with Section 411(b) of the Resolution;

- (b) any Bond canceled by, or delivered for cancellation to, the Trustee because of payment at maturity or redemption or purchase prior to maturity;

- (c) any Bond deemed paid in accordance with the provisions of Section 303 of the Resolution;

- (d) any Bond deemed paid in accordance with the provisions of Section 1101 of the Resolution; and

- (e) any Bond in lieu of or in substitution for which another Bond shall have been authenticated and delivered pursuant to Section 211 of the Resolution, unless proof satisfactory to the Trustee is presented that any Bond for which a Bond in lieu thereof or in substitution therefor shall have been authenticated and delivered is held by a bona fide purchaser, as that term is defined in Article Eight of the Uniform Commercial Code of the State, as amended, in which case both the Bond so substituted and replaced and the Bond or Bonds authenticated and delivered in lieu thereof or in substitution therefor shall be deemed Outstanding.

“Pledged Property” means (a) an undivided interest in the assets of the 1943 Fund, other than any GO Bond Series Bond Proceeds Subaccount, which undivided interest shall be secondary and subordinate to the rights of the holders of Veterans G.O. Bonds to receive payment of debt service thereon from amounts in the 1943 Fund under any general obligation veterans bond act; (b) any amounts held in the Bond Reserve Account; and (c) any amounts in the Loan Loss Account, except amounts in any Rebate Account and *except* that the pledge established in a Series Resolution may be limited in purpose and time, as set forth in the Series Resolution.

“Primary Contract of Purchase Coverage” means coverage in the form of primary mortgage insurance, guaranty (including by United States Department of Veterans Affairs guaranty) or otherwise of loss from Contract of Purchase defaults as provided in the Program Operating Procedures.

“principal” means (a) as such term references the principal amount of a Deferred Interest Bond or Deferred Interest Bonds, the Appreciated Amount thereof; and (b) as such term references the principal amount of any other Bond or Bonds, the principal amount at maturity of such Bond or Bonds.

“Proceeds Account” means the Proceeds Account established pursuant to Section 401 of the Resolution.

“Program” means the finance program of the Department pursuant to which the Department will issue the Bonds and Veterans G.O. Bonds and apply the proceeds thereof to finance Contracts of Purchase.

“Program Acts” means the Veterans’ Farm and Home Purchase Act of 1943 (constituting Article 3 of Chapter 6 of Division 4 of the Veterans Code) and the Veterans’ Farm and Home Purchase Act of 1974 (constituting Article 3.1 of Chapter 6 of Division 4 of the Veterans Code), as now in effect and as they may from time to time hereafter be amended or supplemented.

“Program Operating Procedures” means, at any time, the Department’s program operating procedures governing the discretionary activities of the Department, in the then current form, as described in Section 606 of the Resolution.

“Rating Agency” means, at any time, any bond rating agency, including Fitch, Moody’s and S&P, that shall have rated any of the Bonds at the request of the Department and shall be maintaining ratings on such Bonds at such time.

“Rating Confirmation” means, with respect to any action or financial condition described in the Resolution, written confirmation from each of the Rating Agencies that the taking of such action or the existence of such financial condition shall not cause the outstanding ratings by such respective Rating Agencies of all Bonds which are not rated based solely on the credit of a bond insurer or other guarantor to be withdrawn, downgraded or suspended.

“Rebate Account” means any Account of that name established by the Department pursuant to Section 401(c) of the Resolution.

“Redemption Price” means, with respect to a Bond or portion thereof, the portion of the principal amount of such Bond or portion plus the applicable premium, if any, payable upon redemption thereof in the manner contemplated in accordance with its terms pursuant to the provisions of the Resolution and any Series Resolution.

“Restricted Recoveries” means, as set forth or referenced in the Series Resolution authorizing a Series of Bonds or in a resolution of issuance authorizing a series of Veterans G.O. Bonds, or as otherwise designated in the Program Operating Procedures, that portion of prepayments and scheduled repayments of principal on Contracts of Purchase financed (directly or indirectly) by or credited to such Series of Bonds or series of Veterans G.O. Bonds, respectively, to the extent such amounts are required by the Tax Code or by the terms of such Series Resolution or resolution of issuance, respectively, to be applied to a redemption of Bonds or Veterans G.O. Bonds.

“Revenue Account” means the Revenue Account established pursuant to Section 401 of the Resolution.

“Revenues” means all moneys received by or on behalf of the Department representing (i) principal and interest payments on the Contracts of Purchase including all prepayments representing the same and all prepayment premiums or penalties received by or on behalf of the Department in respect to the Contracts of Purchase, (ii) interest earnings received on the investment of amounts to the extent deposited in the Revenue Account pursuant to Section 502 of the Resolution, (iii) amounts transferred to the Revenue Account from the Bond Reserve Account or the Loan Loss Account and (iv) any other amounts payable by parties executing Contracts of Purchase or private participants in the Program or related to recoveries on defaulted Contracts of Purchase, including origination and commitment fees, servicing acquisition fees, and Liquidation/Insurance Proceeds, except to the extent not included as “Revenues” pursuant to the provisions of any Series Resolution.

“S&P” means Standard & Poor’s Ratings Services, a division of The McGraw-Hill Companies, and includes any successor thereto.

“Series Certificate” means a Certificate of the Department which shall be dated as of the date of sale and shall be executed (or re-executed in final form) and delivered on the date of issuance of the applicable Series of Bonds.

“Series Proceeds Subaccounts” means, collectively, the Revenue Bond Series Proceeds Subaccounts and the GO Bond Series Proceeds Subaccounts.

“Series Recycling Subaccounts” means, collectively, the Revenue Bond Series Recycling Subaccounts and the GO Bond Series Recycling Subaccounts.

“Series Resolution” means a Supplemental Resolution of the Committee authorizing the issuance of a Series of Bonds and including any Series Certificate delivered pursuant thereto.

“Series Restricted Recoveries Subaccounts” means, collectively, the Revenue Bond Series Restricted Recoveries Subaccounts and the GO Bond Series Restricted Recoveries Subaccounts.

“Series Revenue Subaccounts” means, collectively, the Revenue Bond Series Revenue Subaccounts and GO Bond Series Revenue Subaccounts.

“State” means the State of California.

“Supplemental Contract of Purchase Coverage” means the coverage, if any, of loss from Contract of Purchase defaults provided in the Program Operating Procedures which supplements any Primary Contract of Purchase Coverage.

“Supplemental Resolution” means any resolution of the Committee supplementing or amending the Resolution.

“Tax Code” means applicable provisions of the Internal Revenue Code of 1954, as amended, and the Internal Revenue Code of 1986, as amended, and the applicable regulations thereunder.

“Term Bonds” means the Bonds with respect to which Sinking Account Requirements have been established.

“Veterans Code” means the Military and Veterans Code of the State of California.

“Veterans Debenture Fund” means the Veterans Debenture Revenue Fund established in the Treasury of the State by Section 1003.11 of the Veterans Code.

“Veterans General Obligation Bonds” means, as of any given time, general obligation bonds of the State the proceeds of which were required to be deposited in the 1943 Fund (or returned to the General Fund or in the Pooled Money Investment Account in the State Treasury in repayment of amounts withdrawn from said General Fund or the Pooled Money Investment Account and deposited in the 1943 Fund) and which are at such given time outstanding. Veterans General Obligation Bonds are referred to in this Official Statement as “Veterans G.O. Bonds.”

#### **Miscellaneous Definitions (Section 104)**

Unless the context shall otherwise indicate, words which import the singular shall include the plural, and words which import the plural shall include the singular. The word “person” shall mean any individual, corporation, partnership, joint venture, association, joint-stock company, trust, unincorporated organization or government or any agency or political subdivision thereof. The words “of the Resolution,” “herein,” “hereto,” “by the Resolution” and “hereunder” refer to the entire Resolution. The words “interest payment date” mean with respect to any Series of Bonds, the interest payment date(s) established in the applicable Series Resolution, regardless of whether the referenced Bonds are interest-bearing or not. Any reference to a rating category shall mean the category published by a Rating Agency without reference to numbered or lettered annotations or pluses and minuses.

### **Authentication of Bonds (Section 205)**

Only such of the definitive Bonds as shall have endorsed thereon a certificate of authentication substantially in the form set forth in the applicable Series Resolution, duly executed by the Trustee, shall be entitled to any benefit or security under the Resolution. No definitive Bond shall be valid or obligatory for any purpose unless and until such certificate of authentication shall have been duly executed by the Trustee, and such certificate of the Trustee upon any such Bond shall be conclusive evidence that such Bond has been duly authenticated and delivered under the Resolution. The Trustee's certificate of authentication on any definitive Bond shall be deemed to have been duly executed if signed by an authorized officer of the Trustee, but it shall not be necessary that the same officer sign the certificate of authentication on all of the Bonds that may be issued under the Resolution at any one time.

### **Exchange of Bonds (Section 206)**

Subject to, and in accordance with, Section 207 of the Resolution, Bonds, upon surrender thereof at the principal office of the Trustee in Sacramento California, together with an assignment duly executed by the registered owner or his attorney or legal representative in such form as shall be satisfactory to the Trustee, may, at the option of the registered owner thereof, be exchanged for an equal aggregate principal amount of Bonds of like tenor and of the same Series (and subseries, if applicable) and maturity, bearing interest at the same rate, of any denomination or denominations authorized by the Resolution.

### **Negotiability, Registration and Registration of Transfer of Bonds (Section 207)**

The transfer of any Bond may be registered only upon the books kept for the registration of, and registration of transfers of, Bonds upon surrender thereof to the Trustee together with an assignment duly executed by the registered owner or his attorney or legal representative in such form as shall be satisfactory to the Trustee. Upon any such registration of transfer of a Bond, the Department shall execute and the Trustee shall authenticate and deliver in exchange for such Bond a new Bond or Bonds, registered in the name of the transferee, in any denomination or denominations authorized by the Resolution, in an aggregate principal amount equal to the principal amount of such Bond of like tenor and of the same Series (and subseries, if applicable) and maturity and bearing interest at the same rate.

### **Issuance of the Bonds (Section 209)**

Each Series Resolution authorizing the issuance of a Series of Bonds shall specify and determine:

- (a) The authorized principal amount of such Series of Bonds;
- (b) The purposes for which such Series of Bonds are being issued which shall be one or more of the following purposes: (i) the financing of Contracts of Purchase; (ii) the making of such deposits in amounts, if any, required by the Resolution or the Series Resolution to be paid into various Accounts or the direct payment of Costs of Issuance; or (iii) the refunding of all or any part of the Bonds of any Series (including any Bonds not deemed Outstanding under the Resolution pursuant to Section 411(b)) or, to

the extent permitted by law, Veterans G.O. Bonds, including the payment of any redemption premium thereon (or premium, to the extent permitted by law, included in the purchase price if purchased in lieu of redemption);

(c) The maturity date or dates, the amounts of each maturity, and the interest payment dates of the Bonds of such Series;

(d) The interest payment dates, and rate or rates, of the Bonds of such Series or method of determining the same;

(e) The denomination or denominations of, and the manner of dating, numbering and lettering the Bonds of each Series;

(f) In the case of Term Bonds, if any, provision for Mandatory Sinking Account Payments;

(g) The Redemption Price or Redemption Prices, if any, the time or times and the terms and conditions upon which the Bonds of such Series may be redeemed prior to their maturities, including without limitation the method of selection for redemption as among maturities;

(h) The amounts to be deposited from the proceeds of such Series of Bonds in the Accounts created and established by the Resolution and the Series Resolution;

(i) That *notwithstanding* any other provision of the Series Resolution, upon issuance, sale and delivery of such Series of Bonds, so much of such proceeds of the Bonds of such Series shall be credited to the Bond Reserve Account so that the amount in such fund shall be at least equal to the Bond Reserve Requirement calculated immediately after the delivery of such Series of Bonds;

(j) That *notwithstanding* any other provision of the Series Resolution, upon sale and delivery of such Series of Bonds, so much of such proceeds of the Bonds of such Series shall be credited to the Loan Loss Account so that the amount in such fund shall be at least equal to the Loan Loss Requirement calculated immediately after the delivery of such Series of Bonds;

(k) The manner in which Bonds of such Series are to be sold and provisions for the sale thereof;

(l) The form of any credit enhancement or liquidity support for such Series of Bonds; and

(m) Any other provisions deemed advisable by the Department not in conflict with the provisions of the Resolution.

Said Bonds shall be executed substantially in the form and manner set forth in the Resolution and shall be deposited with the Trustee for authentication, but before said Bonds shall

be authenticated and delivered by the Trustee, there shall be on file with the Trustee the following:

(a) A copy, duly certified by an Authorized Representative, of the Resolution and the Series Resolution for such Series of Bonds;

(b) A Certificate of the Department to the effect that no Event of Default shall have occurred and then be continuing;

(c) An opinion of nationally recognized bond counsel stating in the opinion of such counsel that (i) the Resolution and the applicable Series Resolution have been duly adopted and are valid and binding upon the Department and (ii) said Bonds are valid and legally binding special obligations of the Department secured in the manner and to the extent set forth in the Resolution and the applicable Series Resolution and are entitled to the benefit, protection and security of the provisions, covenants and agreements contained therein;

(d) A Cash Flow Statement conforming to the requirements of Section 607 of the Resolution;

(e) With respect to refunding Bonds, a certificate of an Authorized Representative stating that the proceeds (excluding accrued interest but including any premium) of such refunding Bonds, together with any moneys to be withdrawn from the Bond Reserve Account by the Trustee, and any other moneys which have been made available to the Trustee for such purposes, and the principal of and the interest on the investment of such proceeds or any such moneys, will be not less than an amount sufficient to pay the principal of and the redemption premium, if any, on the Bonds to be refunded and the interest which will become due and payable on or prior to the date of their payment or redemption, the expenses in connection with such refunding and to make any required deposits to the Bond Reserve Account and the Loan Loss Account and specifying transfers, if any, from the Series Proceeds Subaccount applicable to the Series of Bonds to be refunded and the refunding Bonds;

(f) With respect to refunding Bonds, if all or part of the refunded Bonds are to be redeemed prior to maturity, irrevocable instructions from an Authorized Representative of the Department to the Trustee to redeem the applicable Bonds;

(g) A Rating Confirmation; and

(h) A request and authorization to the Trustee on behalf of the Department, signed by an Authorized Representative, to authenticate and deliver the Bonds to the purchaser or purchasers therein identified upon payment to the Trustee for the account of the Department of the purchase price therefor.

When the documents mentioned in clauses (a) to (h), inclusive, of Section 209 shall have been filed with the Trustee and when the Bonds described in the Series Resolution mentioned in clause (a) above shall have been executed and authenticated as required by the Resolution, the Trustee shall deliver such Bonds at one time to or upon the order of the purchaser or purchasers



named in the request and authorization mentioned in clause (h) of Section 209, but only upon payment to the Trustee of the purchase price of said Bonds. The Trustee shall be entitled to rely upon such request and authorization as to the amount of such purchase price.

Simultaneously with the delivery of such Bonds the Trustee shall deposit or credit the proceeds of said Bonds into the applicable Revenue Bond Series Proceeds Subaccount of the Proceeds Account. Unless otherwise provided in the applicable Series Resolution, the Trustee shall apply such proceeds together with any other available funds, as follows:

(i) an amount shall be transferred to and deposited to the credit of the Bond Reserve Account such that the amount on deposit in such Account will at least equal the Bond Reserve Requirement (with respect to refunding Bonds, after giving effect to the refunding);

(ii) an amount shall be transferred to and deposited to the credit of the Loan Loss Account such that the amount on deposit in such Account will at least equal the Loan Loss Requirement (with respect to refunding Bonds, after giving effect to the refunding); and

(iii) an amount to be transferred to and deposited into any Account or for any purpose not referred to in clauses (i) or (ii) above as provided in the applicable Series Resolution.

#### **Transfers Outside Book-Entry System (Section 214)**

In the event (i) the Securities Depository (*i.e.*, initially, DTC) determines not to continue to act as Securities Depository for any Series of the Bonds or (ii) the Department and the Trustee determine that the Securities Depository shall no longer so act and the Department delivers a written certificate to the Trustee to that effect, then the Department will discontinue the book-entry system with the Securities Depository with respect to such Series. If the Department and the Trustee determine to replace the Securities Depository with another qualified securities depository, the Department shall prepare or direct the preparation of a new, single, separate, fully registered bond for each of the maturities of the Bonds of such Series, registered in the name of such successor or substitute qualified securities depository or its nominee, or make such other arrangements acceptable to the Department and the Securities Depository as are not inconsistent with the terms of the Resolution or any Supplemental Resolution. If the Department and the Trustee fail to identify another qualified securities depository to replace the Securities Depository, then the Bonds of such Series shall no longer be restricted to being registered in the registration books of the Trustee in the name of the Nominee, but shall be registered in whatever name or names the Bondowner of Bonds transferring or exchanging Bonds shall designate in accordance with the Resolution. Notwithstanding anything in Section 214 of the Resolution to the contrary, the book-entry system may not be discontinued within the period commencing 15 days prior to the date of mailing a notice of redemption and ending on the redemption date specified in such notice.

### **Payments and Notices to the Nominee (Section 215)**

Notwithstanding any other provision of the Resolution or any Supplemental Resolution to the contrary, so long as any Bond is registered in the name of the Nominee, all payments with respect to principal of, premium, if any, and interest on such Bond and all notices with respect to such Bond shall be made and given, respectively, as provided in the applicable Representation Letter or as otherwise instructed by the Securities Depository.

### **Effect of Calling for Redemption (Section 303)**

On the date so designated for redemption if the conditions precedent, if any, to such redemption have been satisfied, any required notice which has not been waived having been given in the manner and under the conditions in the Resolution above provided, the Bonds or portions of Bonds so called for redemption shall become and be due and payable at the Redemption Price provided for redemption of such Bonds or portions thereof on such date, and, if sufficient money or Government Obligations (the principal of and interest on which will provide sufficient money for payment of the Redemption Price and the accrued interest) are held by the Trustee in trust for the owners of the Bonds or portions thereof to be redeemed, as provided in the Resolution, such Bonds or portions thereof shall cease to be Outstanding under the provisions of the Resolution, interest on the Bonds or portions of Bonds so called for redemption shall cease to accrue, such Bonds or portions of Bonds shall cease to be entitled to any benefit or security under the Resolution and the owners of such Bonds or portions of Bonds shall have no rights in respect of the Resolution, except to receive payment of the Redemption Price thereof and the accrued interest thereon to the date of redemption and, to the extent provided in Section 304 of the Resolution, to receive Bonds for any unredeemed portion of Bonds.

### **Establishment of Accounts (Section 401)**

- (a) The Resolution creates the following Accounts within the 1943 Fund:

Proceeds Account

Revenue Bond Series Proceeds Subaccounts

Revenue Bond Series Recycling Subaccounts

GO Bond Series Proceeds Subaccounts

GO Bond Series Recycling Subaccounts

Revenue Account

Revenue Bond Series Restricted Recoveries Subaccounts

Revenue Bond Series Revenue Subaccounts

GO Bond Series Restricted Recoveries Subaccounts

GO Bond Series Revenue Subaccounts

(b) The Resolution creates the following Accounts within the Veterans Debenture Fund and designated as set forth below:

Bond Reserve Account

Series Bond Reserve Subaccounts

Loan Loss Account

Series Loan Loss Subaccounts

(c) Additional Accounts (including for the purpose of depositing amounts required to be rebated to mortgagors or the United States, *i.e.*, a Rebate Account) may be created and designated in Series Resolutions. Any Series Proceeds Subaccount, Series Recycling Subaccount, Series Restricted Recoveries Subaccount and Series Revenue Subaccount may be established with respect to more than one Series of the Bonds, or more than one series of Veterans G.O. Bonds, as set forth in the Series Resolution or Supplemental Resolution or any resolution of issuance governing a series of Veterans G.O. Bonds. Each such Account established with respect to Bonds shall be held by the Trustee, in trust, separate and apart from all other funds of the Department, for the purposes provided in this Resolution, provided that in Series Resolutions, the Department may provide for the deposit of amounts in Accounts, which amounts shall be subject to the lien of this Resolution only for the purposes and period of time set forth in the applicable Series Resolution.

**Proceeds Account (Section 402)**

(a) Upon the issuance of a Series of Bonds or a series of Veterans G.O. Bonds, unless otherwise provided in the applicable Series Resolution or resolution of issuance governing such Veterans G.O. Bonds, respectively, the Trustee shall establish a Series Proceeds Subaccount and a Series Recycling Subaccount within the Proceeds Account applicable to such Series of Bonds or series of Veterans G.O. Bonds. The Trustee shall deposit amounts received in connection with the issuance of Bonds or Veterans G.O. Bonds into the Proceeds Account or any such Subaccount in the amount(s) and at the time(s) set forth in the Series Resolution or resolution of issuance, respectively, authorizing the issuance thereof. Amounts shall also be deposited in the Proceeds Account from a transfer of funds from the Revenue Account pursuant to the provisions of Section 403(c)(11) of the Resolution. Amounts on deposit in the Proceeds Account may be transferred between various Series Proceeds Subaccounts and Series Recycling Subaccounts, as set forth in the Program Operating Procedures.

(b) Moneys in the Proceeds Account shall be withdrawn or transferred therefrom in accordance with law upon requisition of the Department for the purpose of carrying out the provisions of the Bond Act and the Program Acts, including by entering into Contracts of Purchase, and by paying administrative expenses of the Department, including Costs of Issuance.

(c) The Trustee shall transfer from the Proceeds Account any amount specified by the Department from time to time in a Department Request for the purpose of redeeming or purchasing Bonds or Veterans G.O. Bonds or for the purpose of funding the Bond Reserve Account as provided in the applicable Series Resolution, or resolution of issuance, and Program Operating Procedures.

(d) The Trustee shall transfer any amount deposited in a Series Recycling Subaccount to the related Series Restricted Recoveries Subaccount or to the related Series Revenue Subaccount, upon a Department Request in the amount and at the time(s) stated in such Department Request.

(e) Moneys held for the credit of the Proceeds Account shall be transferred to be applied for payment of Bonds or Veterans G.O. Bonds pursuant to Section 410 of the Resolution.

#### **Revenue Account; Application of Revenues (Section 403)**

(a) The Department shall transfer all Revenues to the Trustee for deposit in the Revenue Account upon the Department's identification and receipt thereof. Upon transfer, the Department shall identify the amount of Restricted Recoveries included in such Revenues and deposit the same, unless otherwise provided in the applicable Series Resolution or any resolution of issuance governing a series of Veterans G.O. Bonds, in the related Series Restricted Recoveries Subaccount. The balance shall be deposited in the related Series Revenue Subaccount.

(b) Pursuant to a Department Request, based on the Department's determination that certain Revenues previously deposited in a Series Revenue Subaccount constitute Restricted Recoveries, the Trustee shall transfer Revenues in an amount equal to and representing such Restricted Recoveries from the Series Revenue Subaccount to the related Series Restricted Recoveries Subaccount (if any).

(c) From time to time as required or as otherwise directed by Department Request, the Department shall cause to be transferred, applied, or retained all Revenues in the Revenue Account (not including Series Restricted Recoveries Subaccounts, which shall be governed by Section 409 of the Resolution) for the following purposes (subject, in the case of any deficiency in available Revenues to meet the requirements of one or more of clauses (1) through (6), to the provisions as to deficiency contained in Section 410):

(1) In accordance with the applicable Series Resolution, to transfer to any Rebate Account, or otherwise to the U.S. Treasury, the amount(s) if any, specified by Department Request;

(2) From the GO Bond Series Revenue Subaccounts, to reimburse the General Fund for amounts previously paid out of the General Fund (and not previously reimbursed pursuant to this provision) for principal of and interest on the Veterans G.O. Bonds of the related series (together with interest at the same rate as borne by said bonds, compounded semiannually, from the due date of such principal and interest to the date of such reimbursement);

(3) From the GO Bond Series Revenue Subaccounts, to transfer to the General Fund the amount of the principal of and interest then due on the Veterans G.O. Bonds of the related series and the amount of Credit and Liquidity Support Expenses then due and related thereto;

(4) From the Revenue Bond Series Revenue Subaccounts, to pay interest due on the Bonds of the related Series;

(5) From the Revenue Bond Series Revenue Subaccounts, to pay principal (including by operation of Mandatory Sinking Account Payments) due on the Bonds of the related Series;

(6) From the Revenue Bond Series Revenue Subaccounts, to pay any Credit and Liquidity Support Expenses then due and related to the Bonds of the related Series;

(7) From the Revenue Bond Series Revenue Subaccounts, upon Department Request and (without Department Request) at least once every month, to deposit to the credit of the Bond Reserve Account an amount sufficient to cause the amount on deposit in said Account to equal the Bond Reserve Requirement (to be allocated among any Revenue Bond Series Bond Reserve Subaccounts in accordance with the Program Operating Procedures);

(8) From the Revenue Bond Series Revenue Subaccounts, pursuant to the terms of a Series Resolution upon the issuance of a Series of Bonds, to transfer such amount as is required to cause the amount in the Loan Loss Account to equal the Loan Loss Requirement;

(9) From all Series Revenue Subaccounts pursuant to Program Operating Procedures to transfer an amount to the Department for deposit to any operating or other account, free and clear of the lien of the Resolution, equal to Expenses specified in a Department Request as contemplated by the Program Operating Procedures;

(10) From the GO Bond Series Revenue Subaccounts, on the first day of each month, to accumulate in the GO Bond Series Revenue Subaccounts collectively (in such respective allocations made at such times as are required by the Program Operating Procedures), an amount equal to Accrued Debt Service on the Veterans G.O. Bonds of all series;

(11) From any Series Revenue Subaccount, upon Department Request, to transfer amounts for credit to the related Series Recycling Subaccount; and

(12) With respect to amounts constituting Excess Revenues or Restricted Recoveries, to redeem any Series of Bonds or series of Veterans G.O. Bonds upon Department Request and in accordance with the provisions of a Series Resolution or Supplemental Resolution, or resolution of issuance governing such Veterans G.O. Bonds, respectively.

(d) Revenues in the Revenue Account shall be applied to the purchase of Bonds at the times, in the manner and for the purposes set forth in Section 406 of the Resolution.

(e) Amounts on deposit in the Revenue Account upon Department Request may be transferred between any Series Restricted Recoveries Subaccount or Series Revenue Subaccount and any other Series Restricted Recoveries Subaccount or Series Revenue Subaccount, as set forth in the Program Operating Procedures.

#### **Interest (Section 404)**

In payment of interest on Bonds, the Trustee shall remit (or other method of transfer acceptable to the Department and to any Securities Depository) (i) by mail to each owner of Bonds the amounts required for paying the interest on such Bonds as such interest becomes due and payable and (ii) payment for any Credit and Liquidity Support Expenses relating to such Bonds as described in Section 403(c)(6) of the Resolution. An Authorized Representative of the Department shall advise the Trustee regarding the amount of any such Credit and Liquidity Support Expenses and when payment is due.

#### **Principal (Section 405)**

(a) Principal Payments. The Trustee shall set aside in the Revenue Account for remittance to Bondowners the amounts required for paying the principal of all Bonds as such principal becomes due and payable.

(b) Mandatory Sinking Account Payments Redemption. Amounts on deposit in any Revenue Bond Series Revenue Subaccount prior to being applied in satisfaction of Mandatory Sinking Account Payments shall be applied as applicable to the purchase of Term Bonds of the related Series then Outstanding subject to Mandatory Sinking Account Payments on the next date such payments are scheduled as provided in this paragraph. The Trustee, upon direction of an Authorized Representative, shall endeavor to purchase the Term Bonds or portions of Term Bonds of each Series stated to mature on the next maturity date or to be redeemed pursuant to Mandatory Sinking Account Payments for Term Bonds of such Series then Outstanding at a price not to exceed the Redemption Price (plus accrued interest to the date of redemption) which would be payable on the next redemption date to the Owners of such Term Bonds under the provisions of the applicable Series Resolution if such Term Bonds or portions of Term Bonds should be called for redemption on such date. *Provided, however,* that, subject to applicable law, *notwithstanding* the maximum purchase price set forth in the preceding sentence, if at any time the investment earnings on the moneys in the Revenue Account equal to the Mandatory Sinking Account Payments for the next date such payments are scheduled shall be less than the interest accruing on the Bonds to be redeemed on such date from such Mandatory Sinking Account Payments, then the Trustee may pay a purchase price for any such Bond in excess of the Redemption Price which would be payable on the next redemption date to the owner of such Bond under the provisions of the applicable Series Resolution, if an Authorized Representative certifies to the Trustee that the amount paid in excess of said Redemption Price is expected to be less than the interest which is expected to accrue on said Bond less any investment earnings on such available moneys during the period from the settlement date of the proposed purchase to the redemption date. The Trustee shall pay the interest accrued on such Term Bonds or portions of

Term Bonds to the date of settlement therefor from the Revenue Account. *Notwithstanding* the foregoing, no such purchase shall be made by the Trustee after the giving of notice of redemption by the Trustee.

(c) Any purchase or redemption of Bonds shall be made pursuant to the provisions of Article III of the Resolution. Upon retirement of any Term Bonds by purchase or redemption pursuant to the provisions of Section 405 of the Resolution, the Trustee shall file with the Department a statement identifying such Bonds and setting forth the date of their purchase or redemption, the amount of the purchase price or the Redemption Price of such Bonds and the amount paid as interest thereon. The expenses in connection with the purchase or redemption of any such Bonds shall be paid by the Trustee from any moneys available therefor in the Revenue Account.

### **Redemption (Section 406)**

(a) The Trustee shall apply all amounts in Revenue Bond Series Restricted Recoveries Subaccounts, and all moneys otherwise set aside in the Revenue Account for the redemption of Bonds pursuant to Section 403(c)(12) of the Resolution, to the purchase or redemption of Bonds issued under the provisions of the Resolution, as follows:

(1) The Trustee, upon direction of an Authorized Representative, shall endeavor to purchase Bonds or portions of Bonds then Outstanding, whether or not such Bonds or portions of Bonds shall then be subject to redemption, at a price not to exceed the Redemption Price (plus accrued interest, if any, to the date of redemption) which would be payable on the next redemption date to the owners of such Bonds if such Bonds or portions of Bonds should be called for redemption on such date from the moneys in the respective Account. Such maximum purchase price may be exceeded in accordance with the proviso in Section 405(b) of the Resolution. The Trustee shall pay the interest accrued on such Bonds to the date of settlement therefor from the Revenue Account, but no such purchase shall be contracted for by the Trustee after the giving of notice by the Trustee that such Bonds have been called for redemption except from moneys other than the moneys set aside for the redemption of such Bonds.

(2) The Trustee, having endeavored to purchase Bonds pursuant to subsubsection (1) of this subsection (a), shall call for redemption, on the earliest practicable date on which Bonds are subject to redemption from such moneys, such amount (computed on the basis of Redemption Prices) of Bonds as will exhaust the moneys set aside for such redemption, as nearly as may be practicable.

(b) Any purchase or redemption of Bonds shall be made pursuant to the provisions of Article III of the Resolution. Prior to calling Bonds or portions of Bonds for redemption, the Trustee shall set aside the respective amounts required for paying the interest on and the Redemption Price of the Bonds or portions of Bonds so called for redemption. Upon the retirement of any Bonds under Section 406 of the Resolution by purchase or redemption, the Trustee shall file with the Department a statement briefly describing such Bonds and setting forth the date of their purchase or redemption, the amount of the purchase price or the Redemption Price of such Bonds and the amount paid as interest thereon. The expenses in connection with

the purchase or redemption of any such Bonds shall be paid by the Trustee from any moneys available therefor in the Revenue Account.

#### **Bond Reserve Account (Section 407)**

(a) Moneys held for the credit of the Bond Reserve Account shall be transferred by the Trustee to be applied for payment of Bonds pursuant to Section 410 of the Resolution.

(b) Moneys held for the credit of the Bond Reserve Account as of any date in excess of the Bond Reserve Requirement upon Department Request shall be transferred to the Loan Loss Account, the Revenue Account or the Proceeds Account.

(c) A Series Resolution may provide that the Bond Reserve Requirement with respect to the applicable Series of Bonds may be funded through Cash Equivalents. In connection with any discussion in the Resolution of "moneys" on deposit in or held for the credit of the Bond Reserve Account, "moneys" shall be deemed to include said Cash Equivalents.

(d) Upon Department Request, the Trustee shall transfer an amount required to cause the Bond Reserve Account to equal the Bond Reserve Requirement from available amounts in the 1943 Fund.

#### **Loan Loss Account (Section 408)**

(a) Pursuant to the Program Operating Procedures, moneys held for the credit of the Loan Loss Account as of any date upon Department Request shall be transferred to the Revenue Account, the Bond Reserve Account, the Proceeds Account or any GO Bond Series Revenue Subaccount.

(b) A Series Resolution may provide that the Loan Loss Requirement with respect to the applicable Series of Bonds may be funded through Cash Equivalents. In connection with any discussion in the Resolution of "moneys" on deposit in or held for the credit of the Loan Loss Account, "moneys" shall be deemed to include said Cash Equivalents.

(c) Moneys held for the credit of the Loan Loss Account shall be transferred by the Trustee to be applied for payment of Bonds, pursuant to Section 410 of the Resolution.

(d) Upon Department Request, the Trustee shall transfer an amount required to cause the Loan Loss Account to equal the Loan Loss Requirement from available amounts in the 1943 Fund.

(e) To the extent set forth in a Department Request, the Trustee shall apply amounts in the Loan Loss Account to remedy shortfalls in recoveries on Contracts of Purchase financed by or otherwise allocable to the Veterans G.O. Bonds of any series.

#### **Restricted Recoveries (Section 409)**

Upon the issuance of a Series of Bonds or series of Veterans G.O. Bonds, if so required by the terms of the Series Resolution or resolution of issuance governing the Veterans G.O.



Bonds, the Trustee shall establish a Series Restricted Recoveries Subaccount within the Revenue Account applicable to such Series of Bonds or series of Veterans G.O. Bonds. If the Trustee does not receive a Department Request with respect to a mandatory redemption from Restricted Recoveries set forth in a Series Resolution, the Trustee shall apply Restricted Recoveries in an amount sufficient to accomplish such mandatory redemption to a redemption of Bonds (subject to any other priority set forth in the applicable Series Resolution) on a *pro rata* basis, as nearly as practicable, from among each maturity of the Series (and subseries, if applicable) of Bonds which financed the related Contracts of Purchase. Upon Department Request, the Trustee shall transfer amounts in any Series Restricted Recoveries Subaccount to the related Series Revenue Subaccount.

#### **Deficiencies in Debt Service (Section 410)**

In the event that amounts in the Revenue Account shall be insufficient on any interest payment date or principal payment date for the Bonds or the Veterans G.O. Bonds to pay the principal of and interest on such Bonds, or provide for payment with respect to Veterans G.O. Bonds pursuant to the provisions of Section 403(c)(2) or (3) of the Resolution in each case if payment is due and unpaid on such date, whether at the stated payment or maturity date or by the retirement thereof by Mandatory Sinking Account Payments (or sinking account retirement with respect to the Veterans G.O. Bonds) therefor, the Trustee shall withdraw amounts from the following Accounts in the following order of priority to the extent necessary to eliminate such deficiency; *provided, however*, that no amounts shall be used for such purpose to the extent that such amounts have been set aside for the payment of Bonds or Veterans G.O. Bonds which have been identified for purchase pursuant to Section 403 or 406 of the Resolution or called for redemption, and no amounts on deposit in the Proceeds Account shall be used for such purpose to the extent that the Department is contractually obligated to enter into Contracts of Purchase acceptable for financing with such amounts:

(a) With respect to deficiencies in payments related to Veterans G.O. Bonds, in the following order of priority:

- (i) GO Bond Series Recycling Subaccounts;
- (ii) GO Bond Series Proceeds Subaccounts;
- (iii) GO Bond Series Restricted Recoveries Subaccounts;
- (iv) Revenue Bond Series Revenue Subaccounts;
- (v) Revenue Bond Series Recycling Subaccounts;
- (vi) Revenue Bond Series Proceeds Subaccounts; and
- (vii) Revenue Bond Series Restricted Recoveries Subaccounts.

(b) With respect to deficiencies in debt service related to Bonds, in the following order of priority:

- (i) Revenue Bond Series Recycling Subaccounts;
- (ii) Revenue Bond Series Proceeds Subaccounts;
- (iii) Revenue Bond Series Restricted Recoveries Subaccounts;
- (iv) GO Bond Series Revenue Subaccounts;
- (v) GO Bond Series Recycling Subaccounts;
- (vi) GO Bond Series Proceeds Subaccounts;
- (vii) GO Bond Series Restricted Recoveries Subaccounts;
- (viii) Loan Loss Account; and
- (ix) Bond Reserve Account.

#### **Moneys Held in Trust (Section 411)**

(a) All moneys which the Trustee shall have withdrawn or set aside for the purpose of payment of any of the Bonds secured by the Resolution, either at the maturity thereof or upon call for redemption, shall be held in trust for the respective owners of such Bonds and such moneys shall not be subject to lien or attachment by any creditor of the Department or the Trustee. Any moneys which shall be so set aside by the Trustee and which shall remain unclaimed by the owners of such Bonds for the period of two (2) years after the date on which such Bonds or the interest thereon shall have become due and payable shall be paid to the Department or to such officer, board or body as may then be entitled by law to receive the same, and thereafter the owners of such Bonds shall look only to the Department or to such officer, board or body, as the case may be, for payment and then only to the extent of the amounts so received without any interest thereon, and the Trustee shall have no responsibility with respect to such moneys.

(b) If sufficient money or Government Obligations (the principal of or interest on which will provide sufficient money for payment of the principal amount or accrued interest on the Bonds on their maturity date or each date thereafter that they become due by redemption or otherwise) are held by the Trustee in trust for the Owners of Bonds, such Bonds shall cease to be Outstanding under the provisions of the Resolution, interest on the Bonds which have matured shall cease to accrue, such Bonds shall cease to be entitled to any benefit or security under the Resolution, and the owners of such Bonds shall have no rights in respect thereof, except to receive payment of the principal amount thereof and accrued interest thereon to the maturity date. Notwithstanding any provision of the Resolution to the contrary, the Department may issue refunding Bonds to refund the liabilities remaining on any such Bonds, despite their characterization for other purposes as not Outstanding under the Resolution.

### **Security for Deposits (Section 501)**

All money deposited with a co-Trustee in any Account created under the Resolution shall, unless invested in Investment Obligations in accordance with Section 502 (except, to the extent applicable, the last paragraph of Section 502) of the Resolution, to the extent such deposits are in excess of the amount guaranteed by the Federal Deposit Insurance Corporation or other Federal agency, be continuously secured (if permitted by law), for the benefit of the Department and the owners of the Bonds either (a) by lodging with a bank or trust company selected by the Department as custodian, or, if then permitted by law, by setting aside under control of the trust department of the bank holding such deposit as collateral security, Government Obligations or, with the approval of the Department, other marketable securities eligible as security for the deposit of trust funds under regulations of the Comptroller of the Currency of the United States of America, having a market value at all times (exclusive of accrued interest) not less than the amount of such deposit; or (b) if the furnishing of security as provided in clause (a) of Section 501 of the Resolution is not permitted by applicable law, then in such other manner as may then be required or permitted by applicable State or Federal laws and regulations regarding the security for, or granting a preference in the case of, the deposit of trust funds; *provided, however*, that it shall not be necessary, *except* as otherwise expressly provided, for the Trustee to give security for any money which shall be represented by obligations purchased under the provisions of Article V of the Resolution as an investment of such money.

### **Investment of Moneys (Section 502)**

The Revenue Bond Series Proceeds Subaccounts, Series Recycling Subaccounts, Series Restricted Recoveries Subaccounts, Series Revenue Subaccounts, Loan Loss Account and Bond Reserve Account shall, as nearly as is practicable, be fully and continuously invested or reinvested in Investment Obligations.

Any Investment Obligations so purchased in any Account shall be deemed at all times to be part of such Account. Any interest paid on the investment in any Account (*except* any Rebate Account) shall be credited to the Revenue Account and thereafter treated as Revenues. Any interest paid on the investment of any Rebate Account shall be credited to such Rebate Account. Any profit or loss resulting from such investment shall be credited to or charged against the Account. The Trustee shall sell or present for redemption any obligations so purchased whenever it shall be necessary so to do in order to provide money to meet any payment or transfer from any such Account. Neither the Trustee nor the Department shall be liable or responsible for any loss resulting from any such investment.

### **Covenant Against Encumbrances (Section 605)**

The Department covenants that, except as expressly permitted in the Resolution, it will not sell, convey, mortgage, encumber or otherwise dispose of the money held for the credit of any Account created under the Resolution except the pledge created by the Resolution and any interest or right to which such pledge is by its terms secondary and subordinate or take any other action which would adversely affect the security of the Bondowners stated in the Resolution.

### **Program Operating Procedures (Section 606)**

(a) The Department shall have on file with the Trustee at all times during which Bonds are Outstanding current Program Operating Procedures accompanied by a Counsel's Opinion that the same are consistent with the provisions of the Resolution.

(b) Upon adoption of Program Operating Procedures, the Department shall thereafter administer the Program and perform its obligations under the Resolution in accordance in all material respects with the Program Operating Procedures. Any action taken by the Department with respect to Contracts of Purchase, Bonds and Pledged Property shall be deemed a representation and warranty by the Department under the Resolution that such action is in conformance with any provision of the current Program Operating Procedures applicable thereto.

(c) The Program Operating Procedures may be amended only if (1) a Cash Flow Statement is delivered to the Trustee and (2) an opinion of nationally recognized bond counsel is delivered to the Trustee to the effect that such amendment or action taken pursuant to such amendment will not affect the exemption of interest on the Bonds from the gross income of the holders thereof for federal income tax purposes.

### **Cash Flow Statements (Section 607)**

(a) The Department shall file with the Trustee a current Cash Flow Statement (i) upon adoption of each Series Resolution and each Supplemental Resolution, (ii) upon issuance of any series of Veterans G.O. Bonds, (iii) when required pursuant to any Series Resolution or Supplemental Resolution, (iv) upon any change in the Program Operating Procedures and (v) whenever required pursuant to the provisions of Section 608 of the Resolution. The Department may file a new or amended Cash Flow Statement conforming to the requirements of Section 607 of the Resolution at any time. Any Cash Flow Statement shall be the subject of a Rating Confirmation if it does not include all the scenarios included in the Cash Flow Statement previously on file with the Trustee.

(b) A Cash Flow Statement shall consist of a Certificate of the Department containing the conclusion of an Authorized Representative of the Department that projected Revenues will be sufficient to provide for timely payments of interest and principal on the Bonds and Expenses, under each of the scenarios included in the cash flow projections attached to the Resolution. The Cash Flow Statement shall include each scenario included in the immediately prior Cash Flow Statement except as may be required by any Rating Agency in connection with a Rating Confirmation. A Cash Flow Statement shall (i) take into account the financial position of the 1943 Fund, the Bond Reserve Account and the Loan Loss Account as of the stated starting date of the projection; (ii) reflect all the significant transactions that have occurred in the period commencing with such starting date and ending with a date no more than ninety (90) days prior to the date of such projections; (iii) be consistent with the Resolution; and (iv) assume compliance with the Program Operating Procedures.

(c) The Cash Flow Statement shall set forth for each scenario included therein the sets of assumptions on which it is based including, without limitation, the following:

(i) the timing and terms of issuance or remarketing of Bonds and Veterans G.O. Bonds;

(ii) the timing of the acquisition of Contracts of Purchase and the interest rates thereon and maturities thereof;

(iii) the timing and amounts of the receipt of payments of scheduled principal or and interest on Contracts of Purchase;

(iv) the timing and amounts of prepayments on Contracts of Purchase;

(v) the timing and amount of defaults on Contracts of Purchase and disposition or recovery prices of defaulted Contracts of Purchase, which assumption may be based on a specified model of default frequency and loss severity as a function of Contract of Purchase portfolio characteristics;

(vi) the investment return on Accounts and subaccounts, to the extent that amounts on deposit will not be subject to an investment agreement;

(vii) the performance by the Department's counterparty with respect to obligations under an enhancement agreement or arrangement for Supplemental Contract of Purchase Coverage or investment of funds;

(viii) the types of Primary Contract of Purchase Coverage and Supplemental Contract of Purchase Coverage; and

(ix) the Loan Loss Requirement.

(d) If any Cash Flow Statement shall show that projected Revenues shall be insufficient to provide for timely payments of interest on and principal of the Bonds and Expenses, the Department shall not be in default under the Resolution but shall take all reasonable actions to eliminate such deficiency. The Department shall be precluded from taking the actions described or referenced in clauses (i) through (iv) of subsection (a) of the first paragraph of this section – “Cash Flow Statements” – if the Cash Flow Statement on file with the Trustee in accordance with the requirements of the first paragraph of this section shall show that the taking of such action shall cause a deficiency to occur or shall increase any existing deficiency.

#### **Maintenance of Fund Parity (Section 608)**

The Department shall cause a calculation to be made of Fund Parity, as evidenced in a Certificate of the Department filed with the Trustee as of the last day of each Fiscal Year (and upon receipt of the audited financial statements of the 1943 Fund), or more frequently in the discretion of the Department. If any such calculation shall not reflect that Fund Parity at least

equals the Applicable Fund Parity Percentage<sup>(1)</sup> (provided that any Applicable Fund Parity Percentage which is less than 50% shall be the subject of a Rating Confirmation) of the then Outstanding aggregate principal amount of Bonds, all Excess Revenues shall thereafter be applied to redeem Bonds of the Series and in the manner reflected in the current Cash Flow Statement until (and if) the Department files with the Trustee a new Certificate of the Department reflecting a calculation of Fund Parity that at least equals such 50% (or such other percentage) level; *provided, however*, that no such Cash Flow Statement and no such redemption shall be required under the Resolution if the Department shall have provided a Rating Confirmation to the Trustee. But see “SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS – Maintenance of Fund Parity” for the current percentage.

### **Tax Covenants (Section 609)**

The Department shall at all times perform the applicable tax covenants contained in any applicable Series Resolution. In addition, the Department shall not amend the interest rates on any existing Contracts of Purchase unless the Department shall have provided the Trustee with an opinion of nationally recognized bond counsel to the effect that such action will not impair any exclusion of interest on the Bonds issued with the intent that such interest be excluded from gross income for federal income tax purposes. The Department shall prohibit any person (or any related person, as defined in Section 147(a)(2) of the Tax Code) for whom the Department may finance Contracts from purchasing Bonds of any other obligations issued by the Department to carry out the purposes of the Program in an amount related to the amount of the Contracts to be financed under the Program for such person by the Department.

### **Books and Records (Section 611)**

(a) The Trustee shall keep proper books of record and account in which complete and correct entries shall be made of all transactions relating to the receipts, disbursements, allocations and applications of all moneys received by the Trustee under the Resolution, and such books shall be available for inspection by the Department and any Bondowner during business hours, upon reasonable notice and under reasonable conditions.

(b) The Department shall keep proper books of records and account for all its transactions, other than those recorded in the books maintained by the Trustee pursuant to subsection (a) of Section 611 of the Resolution, and such books shall be available for inspection by the Trustee and any Bondowner during business hours and upon reasonable notice.

### **Annual Audit, Report and No-Default Certificate (Section 612)**

By the first day of the tenth month after the end of each Fiscal Year, the Department shall furnish to the Trustee (i) a statement of the revenues and expenses and of the changes in the fund balances during the previous Fiscal Year, in each case with respect to the 1943 Fund, the Bond Reserve Account and the Loan Loss Account, certified to by an Accountant; and (ii) a certificate from an Authorized Representative stating that there is no current Event of Default and that no

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<sup>1</sup> Currently, the Applicable Fund Parity Percentage is 25%. Such Applicable Fund Parity Percentage has been subject to Rating Agency Confirmation. See “SECURITY FOR AND SOURCES OF PAYMENTS FO THE REVENUE BONDS – Maintenance of Fund Parity.”

Event of Default occurred during the preceding Fiscal Year (or if there has been an Event of Default, providing the details of the Resolution and describing the steps the Department took, or is taking, to cure such Event of Default).

#### **Program Covenants (Section 614)**

The Department shall from time to time, with all practical dispatch and in a sound and economical manner consistent in all respects with the Bond Act, the Program Acts, the Resolution and all other applicable laws and regulations and with sound banking practices and principles, use and apply the amounts held in the 1943 Fund and available therefor to the financing of Contracts of Purchase and to other uses permitted under the Resolution and the law, and shall take all steps, actions and proceedings reasonable and necessary in the judgment of the Department to enforce the terms, covenants and conditions of each Contract of Purchase.

#### **Issuance of Additional Obligations and Subordinate Obligations (Section 615)**

The Department, so long as any Bonds shall be Outstanding under the Resolution, shall not issue any bonds, notes or other evidences of indebtedness, other than the Bonds, secured by any pledge of or other lien or charge on the Pledged Property nor shall the Department create or cause to be created any lien or charge on the Pledged Property, other than the lien and pledge created under the Resolution and other than the rights of the State or the holders of the Veterans G.O. Bonds. Nothing contained in Section 615 of the Resolution shall prevent the Department from issuing any bonds, notes or other evidences of indebtedness which are payable from or secured by a lien and pledge on the Pledged Property provided that payment of such evidences of indebtedness and such lien and pledge shall be in all respects subordinate to the provisions of the Resolution and the lien and pledge created by the Resolution and any such evidences of indebtedness shall contain an appropriate recital with respect to such subordination.

#### **Events of Default Defined (Section 702)**

Each of the following events is by the Resolution declared an "Event of Default," that is to say: If

(a) payment of the principal or Redemption Price of any of the Bonds shall not be made when the same shall become due and payable, either at maturity or by proceedings for redemption or otherwise; or

(b) payment of any installment of interest on any of the Bonds shall not be made when the same shall become due and payable; or

(c) the entry of a decree or order for relief by a court having jurisdiction in the premises in respect of the Department in an involuntary case under the Federal bankruptcy laws, as now or thereafter constituted, or any other applicable Federal or State bankruptcy, insolvency or other similar law, or appointing a receiver, liquidator, assignee, custodian, trustee, sequestrator (or similar official) of the Department or for any substantial part of its property, or ordering the winding-up or liquidation of its affairs and the continuance of any such decree or order unstayed and in effect for the period of 60 consecutive days; or

(d) the commencement by the Department of a voluntary case under the Federal bankruptcy laws, as constituted under the Resolution or hereafter amended, or any other applicable Federal or State bankruptcy, insolvency or other similar law, or the consent by it to the appointment of or taking possession by a receiver, liquidator, assignee, trustee, custodian, sequestrator (or other similar official) of the Department or for any substantial part of its property or the making by it of any assignment for the benefit of creditors, or the taking of action by the Department in furtherance of any of the events under Section 702 of the Resolution; or

(e) failure by the Department to pay, when due or within any applicable grace period, any amount owing on account of indebtedness for money borrowed or for deferred purchases of property, or the failure by the Department to observe or perform any covenant or undertaking on its part to be observed or performed in any agreement evidencing, securing or relating to such indebtedness, resulting, in any such case, in an event of default or acceleration by the holder of such indebtedness of the date on which such indebtedness would otherwise be due and payable; or

(f) the Department defaults in the due and punctual performance of any other covenants or agreements contained in the Bonds or in the Resolution and such default continues for 90 days after written notice requiring the same to be remedied shall have been given to the Department by the Trustee, which may give such notice in its discretion and shall give such notice at the written request of the owners of not less than twenty per centum (20%) in aggregate principal amount of Bonds then Outstanding; *provided, however*, that so long as following such notice the Department is diligently taking actions to remedy such default, such default shall not be an Event of Default.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including the 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds) Outstanding under the Resolution, Ambac Assurance Corporation (“the Insurer”), as the provider of the respective financial guaranty insurance policies with respect to the 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds will be deemed to be the owner of the 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds.

#### **Enforcement of Remedies (Section 704)**

Upon the happening and continuance of any Event of Default specified in Section 702 of the Resolution, then and in every such case the Trustee may, and upon the written direction of the owners of not less than twenty per centum (20%) in aggregate principal amount of the Bonds then Outstanding under the Resolution shall, proceed, subject to the provisions of Section 802 of the Resolution, to protect and enforce its rights and the rights of the Bondowners under applicable laws or under the Resolution by such suits, actions or special proceedings in equity or at law, or by proceedings in the office of any board or officer having jurisdiction, either for the specific performance of any covenant or agreement contained in the Resolution or in aid or execution of any power in the Resolution granted or for the enforcement of any proper legal or equitable remedy, as the Trustee, being advised by counsel, shall deem most effectual to protect and enforce such rights.



Regardless of the happening of an Event of Default, the Trustee may, and, subject to Section 802 of the Resolution, if requested in writing by the owners of not less than twenty per centum (20%) in aggregate principal amount of the Bonds then Outstanding, shall institute and maintain such suits and proceedings as it may be advised shall be necessary or expedient (i) to prevent any impairment of the Pledged Property by any acts which may be unlawful or in violation of the Resolution or of any Series Resolution or (ii) to preserve or protect the interest of the Bondowners, provided that such request is in accordance with law and the provisions of the Resolution and, in the sole judgment of the Trustee, is not unduly prejudicial to the interests of the owners of Bonds not making such request.

If a covenant is set forth in a Series Resolution, limitations on the remedies available upon an Event of Default related to such covenant may be set forth in said Series Resolution.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds) Outstanding under the Resolution, the Insurer will be deemed to be the owner of the 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds.

#### ***Pro Rata Application of Funds (Section 706)***

Anything in the Resolution to the contrary notwithstanding, if at any time the money in the Accounts maintained under the Resolution (other than any Rebate Account) shall not be sufficient to pay the principal of or interest on the Bonds as the same shall become due and payable such money, together with all amounts then on deposit in the 1943 Fund other than Veterans G.O. Bonds proceeds, together with any money then available or thereafter becoming available for such purpose, whether through the exercise of the remedies provided for in Article VII or otherwise, shall be applied, following the satisfaction of any payments due to the Trustee under the provisions of Section 802 and 805 of the Resolution, as follows:

(a) Except in the case of amounts on deposit in the Bond Reserve Account and the Loan Loss Account and interest, profit or other income derived from the investment of such amounts, for transfer to the General Fund in the State Treasury in accordance with and at the times stated in Sections 403(c)(2) and (3) of the Resolution.

(b) After application pursuant to clause (a) of Section 706 of the Resolution, all such money shall be applied:

First: to the payment to the persons entitled thereto of all installments of interest on Bonds (*except* interest on overdue principal) then accrued and unpaid in the chronological order in which such installments of interest accrued and, if the amount available shall not be sufficient to pay in full any particular daily installment, then to the payment, ratably, according to the amounts due on such daily installment, to the persons entitled thereto as owners of Bonds, without any discrimination or preference except as to any difference in the respective rates of interest specified in the Bonds;

Second: to the payment to the persons entitled thereto of the unpaid principal of any of the Bonds which shall have become due and payable (*except* Bonds called for redemption for the payment of which money is held pursuant to the provisions of the Resolution) in the order of their stated payment dates, with interest on the principal amount of such Bonds at the respective rates specified in the Resolution from the respective dates upon which such Bonds became due and payable, and, if the amount available shall not be sufficient to pay in full the principal of the Bonds by their stated terms due and payable on any particular date, together with such interest, then to the payment first of such interest, ratably, according to the amount of such interest due on such date, with such payment being made to owners of Bonds, and then to the payment of such principal, ratably, according to the amount of such principal due on such date, to the persons entitled thereto as owners of Bonds, without any discrimination or preference except as to any difference in the respective rates of interest specified in the Bonds;

Third: to the payment of the interest on and the principal of the Bonds, to the purchase and retirement of Bonds and to the redemption of the Bonds, all in accordance with the provisions of Article III of the Resolution.

The provisions of subsection (a) of Section 706 of the Resolution are in all respects subject to the provisions of Section 701 of the Resolution.

(c) Whenever money is to be applied by the Trustee pursuant to the provisions of Section 706 of the Resolution, such money shall be applied by the Trustee at such times, and from time to time, as the Trustee in its sole discretion shall determine, having due regard to the amount of such money available for application and the likelihood of additional money becoming available for such application in the future; the deposit of such money with any paying agent, or otherwise setting aside such money, in trust for the proper purpose shall constitute proper application by the Trustee; and the Trustee shall incur no liability whatsoever to the Department, to any Bondowner or to any other person for any delay in applying any such money, so long as the Trustee acts with reasonable diligence, having due regard to the circumstances, and ultimately applies the same in accordance with such provisions of the Resolution as may be applicable at the time of application by the Trustee. Whenever the Trustee shall exercise such discretion in applying such money, it shall fix the date (which shall be an interest payment date unless the Trustee shall deem another date more suitable) upon which such application is to be made and upon such date interest on the amounts of principal to be paid on such date shall cease to accrue. The Trustee shall give such notice as it may deem appropriate of the fixing of any such date, and shall not be required to make payment to the owner of any Bond until such Bond shall be surrendered to the Trustee for appropriate endorsement, or for cancellation if fully paid.

#### **Owners of Majority in Principal Amount of Bonds May Control Proceedings (Section 708)**

Anything in the Resolution to the contrary *notwithstanding*, the owners of a majority in principal amount of the Bonds then Outstanding under the Resolution shall have the right,

subject to the provisions of Section 802 of the Resolution, by an instrument or concurrent instruments in writing executed and delivered to the Trustee, to direct the method and place of conducting all remedial proceedings to be taken by the Trustee under the Resolution or exercising any trust or power conferred upon the Trustee, provided that such direction shall not be otherwise than in accordance with law and the provisions of the Resolution, and the Act and, in the sole judgment of the Trustee, is not unduly prejudicial to the interests of Bondowners not joining in such direction and *provided, further*, that nothing in Section 708 of the Resolution shall impair the right of the Trustee in its discretion to take any other action under the Resolution which it may deem proper and which is not inconsistent with such direction by Bondowners.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds) Outstanding under the Resolution, the Insurer will be deemed to be the owner of the 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds.

#### **Restrictions Upon Actions by Individual Bondowner (Section 709)**

No owner of any of the Bonds shall have any right to institute any suit, action or proceeding in equity or at law on any Bond or for the execution of any trust under the Resolution or for the enforcement of any remedy under the Resolution unless such owner previously shall have given to the Trustee written notice of the Event of Default on account of which such suit, action or proceeding is to be instituted, and unless, also, the owners of not less than fifteen per centum (15%) in aggregate principal amount of the Bonds then Outstanding shall have made written request of the Trustee after the right to exercise such powers or right of action, as the case may be, shall have accrued, and shall have afforded the Trustee a reasonable opportunity either to proceed to exercise the powers granted in the Resolution or to institute such action, suit or proceeding in its or their name, and *unless*, also, there shall have been offered to the Trustee reasonable security and indemnity against the costs, expenses and liabilities to be incurred therein or by the Resolution, and the Trustee shall have refused or neglected to comply with such request within a reasonable time; and such notification, request and offer of indemnity are by the Resolution declared in every such case, at the option of the Trustee, to be conditions precedent to the execution of the powers and trusts of the Resolution or to any other remedy under the Resolution; *provided, however*, that *notwithstanding* the foregoing provisions of Section 709 of the Resolution and without complying therewith, the owners of not less than twenty per centum (20%) in aggregate principal amount of the Bonds then Outstanding may institute any such suit, action or proceeding in their own names for the benefit of all owners of Bonds under the Resolution. It is understood and intended that, *except* as otherwise provided in the Resolution, no one or more owners of the Bonds by the Resolution secured shall have any right in any manner whatever by his or their action to affect, disturb or prejudice the security of the Resolution, or to enforce any right under the Resolution except in the manner in the Resolution provided, that all suits, actions and proceedings at law or in equity shall be instituted, had and maintained in the manner provided in the Resolution and for the benefit of all owners of such Outstanding Bonds, and that any individual right of action or other right given to one or more of such owners by law is restricted by the Resolution to the rights and remedies provided in the Resolution.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds) Outstanding under the Resolution, the Insurer will be deemed to be the owner of the 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds.

### **Waiver of Defaults (Section 713)**

The Trustee may, and upon written direction of the owners of not less than a majority in aggregate principal amount of the Bonds then Outstanding shall, waive any default which in their opinion shall have been remedied before the entry of final judgment or decree in any suit, action or proceeding instituted by them under the provisions of the Resolution or before the completion of the enforcement of any other remedy under the Resolution, but no such waiver shall extend to or affect any other existing or any subsequent default or defaults or impair any rights or remedies consequent thereon.

### **Notice of an Event of Default (Section 714)**

The Trustee shall mail to the Department and to all Bondowners written notice of the occurrence of any Event of Default set forth in Section 702 of Article VII of the Resolution within thirty (30) days after the Trustee shall have received written notice thereof from the Department, subject to the provisions of Section 708 of the Resolution, that any such Event of Default shall have occurred. The Trustee shall not, *however*, be subject to any liability to any Bondowner by reason of a failure to mail any such notice.

### **Acceptance of Trusts (Section 801)**

(a) The Treasurer of the State shall act as trustee for the Department and the owners of the Bonds to receive and disburse all Revenues and other moneys applicable to the payment of the principal of or interest on the Bonds, including moneys in the 1943 Fund and the Veterans Debenture Fund, and otherwise to hold all the offices and to perform all the functions and duties provided in the Resolution to be held and performed by the Trustee, including acting as Bond Registrar pursuant to Section 208 of the Resolution. For purposes of Article VIII of the Resolution only, the term "Trustee" does not include any co-Trustee appointed pursuant to Section 801 of the Resolution.

(b) Upon the occurrence and continuance of an Event of Default, the Department shall, upon the request of the Trustee or of the owners of twenty percent (20%) in aggregate principal amount of the Bonds at the time Outstanding, appoint a co-Trustee to represent and enforce the rights of the owners of the Bonds during the continuance of such or any other concurrent Event of Default.

(c) The Trustee shall, prior to an Event of Default, and after the curing of all Events of Default which may have occurred, perform such duties and only such duties as are specifically set forth in the Resolution. The Trustee and the co-Trustee shall, during the continuance of any Event of Default (which has not been cured), exercise such of the rights and powers vested in the Trustee and co-Trustee by the Resolution, and use the same degree of care and skill in their

exercise, as a prudent person would exercise or use under the circumstances in the conduct of such person's own affairs.

(d) The Department may at any time or from time to time appoint one or more Paying Agents, in addition to the Trustee and the co-Trustee, for the purpose of paying the principal or Redemption Price of and the interest on the Bonds of any Series. Each Paying Agent shall signify its acceptance of the duties and obligations imposed on it by the Resolution by executing and delivering to the Department and to the Trustee a written acceptance of the Resolution. The Department may remove any Paying Agent at any time by giving written notice of such removal to such Paying Agent and to the Trustee. Any Paying Agent may at any time resign by giving notice of such resignation to the Department. In the event of the resignation or removal of any Paying Agent, such Paying Agent shall pay over, transfer, assign and deliver any moneys held by it to its successor or, if there be no successor then appointed, to the Trustee. The Department shall give prompt notice to Bondowners of the acceptance of appointment by any successor Paying Agent.

#### **Trustee or Co-Trustee Entitled to Indemnity (Section 802)**

The Trustee or co-Trustee shall be under no obligation to institute any suit, or to take any remedial proceeding under the Resolution, or to enter any appearance or in any way defend in any suit in which it may be named as a defendant, or to take any steps in the execution of the trusts created by the Resolution or in the enforcement of any rights and powers under the Resolution, until it shall be indemnified to its satisfaction against any and all costs and expenses, outlays and counsel fees and other reasonable disbursements, and against all liability; the Trustee or co-Trustee may, nevertheless, begin suit, or appear in and defend suit, or do anything else in its judgment proper to be done by it as such Trustee or co-Trustee, without indemnity, and in such case the Department shall reimburse the Trustee or co-Trustee for all costs and expenses, outlays and counsel fees and other reasonable disbursements properly incurred in connection therewith.

#### **Limitation on Obligations and Responsibilities of Trustee or Co-Trustee (Section 803)**

The Trustee or co-Trustee shall be under no obligation (a) to effect or maintain insurance or to renew any policies of insurance to inquire as to the sufficiency of any policies of insurance carried by the Department; (b) to report, or make or file claims or proof of loss for, any loss or damage insured against or which may occur; or (c) to keep itself informed or advised as to the payment of any taxes or assessments, or to require any such payment to be made. The Trustee or co-Trustee shall be under no obligation to record or file the Resolution, or any other security instruments and financing statements, or continuation statements with respect thereto, except pursuant to directions from the Department, in form and substance satisfactory to the Trustee or co-Trustee, set forth in a Department Request. The Trustee or co-Trustee shall have no responsibility in respect of the validity, sufficiency, due execution or acknowledgment by the Department of this Resolution, or, except as to the authentication thereof, in respect of the validity of the Bonds or the due execution or issuance thereof. The Trustee or co-Trustee shall be under no obligation to see that any duties imposed in the Resolution upon the Department or any party other than itself, or any covenants herein contained on the part of any party other than

itself to be performed, shall be done or performed, and the Trustee or co-Trustee shall be under no obligation for failure to see that any such duties or covenants are so done or performed.

#### **Compensation and Indemnification of Trustee and Co-Trustee (Section 805)**

The Department shall pay, from the Pledged Property, to the Trustee and co-Trustee reasonable compensation for all services performed by it under the Resolution and also all its reasonable expenses, charges and other disbursements and those of its attorneys, agents and employees incurred in and about the administration and execution of the trusts created by the Resolution and the performance of its powers and duties under the Resolution, and from such source only, shall indemnify and save the Trustee and co-Trustee harmless against any liabilities which it may incur in the exercise and performance of its powers and duties under the Resolution.

#### **Notice of Default (Section 807)**

Except upon the happening of any Event of Default specified in clauses (a) and (b) of Section 702 of the Resolution, the Trustee or co-Trustee shall not be obliged to take notice or be deemed to have notice of any Event of Default, unless specifically notified in writing of such Event of Default by the Department or by the owners of not less than twenty per centum (20%) in aggregate principal amount of the Bonds secured by the Resolution and then Outstanding.

#### **Trustee or Co-Trustee Protected in Relying on Certain Documents (Section 810)**

The Trustee and co-Trustee shall be protected and shall incur no liabilities in acting or proceeding, or in not acting or not proceeding, in good faith, reasonably and in accordance with the terms of the Resolution, upon any resolution, order, notice, request, consent, waiver, certificate, statement, affidavit, requisition, bond or other paper or document which it shall in good faith reasonably believe to be genuine and to have been adopted or signed by the proper board or person to have been prepared and furnished pursuant to any of the provisions of the Resolution, or upon the written opinion of any attorney, engineer or accountant believed by the Trustee or co-Trustee to be qualified in relation to the subject matter, and the Trustee or co-Trustee shall be under no duty to make any investigation or inquiry as to any statement contained or matters referred to in such instrument. The Trustee or co-Trustee shall not be under any obligation to see to the recording or filing of the Resolution.

#### **Resignation and Removal of Co-Trustee Subject to Appointment of Successor (Section 811)**

No resignation or removal of the co-Trustee and no appointment of a successor co-Trustee pursuant to Article VIII of the Resolution shall become effective until the acceptance of appointment by the successor co-Trustee under Section 814 of the Resolution.

#### **Resignation of Co-Trustee (Section 812)**

Subject to Section 811 of the Resolution, the co-Trustee may resign and by the Resolution become discharged from the trusts created by the Resolution, by notice in writing to be given to the Department and mailed, first class postage prepaid, to all owners of Bonds at their addresses as they appear on the registration books kept by the Trustee, not less than

sixty (60) days before such resignation is to take effect, but such resignation shall take effect immediately upon the appointment of a new co-Trustee under the Resolution, if such new Trustee or co-Trustee shall be appointed before the time limited by such notice and shall then accept the trusts of the Resolution.

### **Removal of Co-Trustee (Section 813)**

Subject to Section 811 of the Resolution, the co-Trustee may be removed at any time by an instrument or concurrent instruments in writing executed by the Department without the consent of Bondowners or by the owners of not less than a majority in principal amount of the Bonds secured by the Resolution and then Outstanding and filed with the Department. A facsimile copy of each such instrument shall be delivered promptly by the Department to the co-Trustee. The co-Trustee may also be removed at any time for reasonable cause by any court of competent jurisdiction upon the application of the owners of not less than ten per centum (10%) in aggregate principal amount of the Bonds then Outstanding under the Resolution.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds) Outstanding under the Resolution, the Insurer will be deemed to be the owner of the 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds.

### **Appointment of Successor Co-Trustee (Section 814)**

(a) If at any time the co-Trustee shall resign, be removed, be dissolved or otherwise become incapable of acting, or the bank or trust company acting as co-Trustee shall be taken over by any governmental official, agency, department or board, the position of co-Trustee shall thereupon become vacant. If the position of co-Trustee shall become vacant for any of the foregoing reasons or for any other reason, the Department shall cause notice of such appointment to be mailed, first class postage prepaid, to all owners of Bonds at their addresses as they appear on the registration books kept by the Bond Registrar(s).

(b) At any time within one year after any such vacancy shall have occurred, the owners of a majority in principal amount of the Bonds secured by the Resolution and then Outstanding, by an instrument or concurrent instruments in writing, executed by such Bondowners and filed with the Department, may appoint a successor co-Trustee, which shall supersede any co-Trustee theretofore appointed by the Department. Facsimile copies of each such instrument shall be delivered promptly by the Department to the predecessor co-Trustee and to the co-Trustee so appointed by the Bondowners.

(c) If no appointment of a successor co-Trustee shall be made pursuant to the provisions of Section 813 of the Resolution within ten (10) days after the vacancy shall have occurred, the owner of any Bond Outstanding under the Resolution or any retiring co-Trustee may apply to any court of competent jurisdiction to appoint a successor co-Trustee. Such court may thereupon, after such notice, if any, as such court may deem proper and prescribed, appoint a successor co-Trustee.

(d) Any co-Trustee hereafter appointed shall be a bank or trust company duly qualified to do business in the State, duly authorized to exercise corporate trust powers and subject to examination by Federal or State authority, of good standing, and having at the time of its appointment a combined capital and surplus aggregating not less than Fifty Million Dollars (\$50,000,000) as shown on its most recently published report of its financial condition.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds) Outstanding under the Resolution, the Insurer will be deemed to be the owner of the 1998 Series A Bonds, the 2001 Series A Bonds and the 2002 Series A Bonds.

#### **No Implied Duty; Standard of Care (Section 816)**

The Trustee or co-Trustee shall have no duty or obligation *except* as expressly provided in the Resolution and no implied duties or obligations shall be read into the Resolution against the Trustee or co-Trustee. The Trustee or co-Trustee shall not incur any liability for any act or omission in performing its duties under the Resolution, *except* in the case of its own negligence or willful misconduct.

#### **Bondowners' Consent Not Required (Section 1001)**

The Department may, from time to time and at any time, adopt such resolutions supplemental to the Resolution which are filed with the Trustee (which Supplemental Resolutions shall thereafter form a part of the Resolution):

- (a) to cure any ambiguity or defect or omission in the Resolution; or
- (b) to grant to or confer upon the Trustee for the benefit of the Bondowners any additional rights, remedies, powers, authority or security that may lawfully be granted to or conferred upon the Bondowners or the Trustee; or
- (c) to include as pledged revenues or money under, and subject to the provisions of, the Resolution any additional revenues or money legally available therefor; or
- (d) to make any other provisions with respect to matters or questions arising under the Resolution which shall not be inconsistent with the provisions of the Resolution, provided such action shall not materially adversely affect the interests of the Bondowners; or
- (e) to add to the covenants and agreements of the Department in the Resolution other covenants and agreements thereafter to be observed by the Department or to surrender any right or power in the Resolution reserved to or conferred upon the Department; or



(f) to add provisions relating to Bonds with coupons appertaining thereto or Bonds issued with full book-entry delivery, if necessary, if the Department shall determine to so issue Bonds in such form under the Resolution; or

(g) to modify any of the provisions of the Resolution in any respect whatever not otherwise set forth in the Section 1001 of the Resolution; *provided, however*, that either (i) such modification shall apply only to Series of Bonds issued after the effective date of the Supplemental Resolution and shall not materially adversely affect the interests of the owners of Bonds of any Series Outstanding on the effective date of the Supplemental Resolution; or (ii) (a) such modification shall be, and be expressed to be, effective only after all Bonds of any Series Outstanding at the date of the adoption of such Supplemental Resolution shall cease to be Outstanding; and (b) such Supplemental Resolution shall be specifically referred to in the text of all Bonds of any Series authenticated and delivered after the date of the adoption of such Supplemental Resolution and of Bonds issued in exchange therefor or in place thereof; or

(h) to modify, amend or supplement the Resolution or any Supplemental Resolution in such manner as to permit, if presented, the qualification of the Resolution and of the Supplemental Resolution under the Trust Indenture Act of 1939 or any similar Federal statute hereafter in effect or under any state Blue Sky Law; or

(i) to surrender any right, power or privilege reserved to or conferred upon the Department by the terms of the Resolution, provided that the surrender of such right, power or privilege is not contrary to or inconsistent with the covenants and agreements of the Department contained in the Resolution; or

(j) if the subject of a Rating Confirmation and if approved by the Trustee, to add to the definition of Investment Obligations pursuant to the last proviso of the definition thereof; or

(k) [reserved]; or

(l) accompanied by a Rating Confirmation, to make any amendment or supplement necessary to accommodate credit enhancement or liquidity support for any or all Series of Bonds; or

(m) to increase the amount of the combined Bond Reserve Requirement and Loan Loss Requirement to an amount greater than ten percent (10%) of the initial principal amount of all Series of which any Bonds are Outstanding Bonds; or

(n) to amend and supplement provisions of the Resolution regarding the Trustee, and the rights of the Department and the owners of Bonds with respect to appointment and replacement of the Trustee, in the event and to the extent the laws of the State are amended to allow an institution other than the State Treasurer to act as Trustee, provided, that any such institution shall meet the qualifications set forth in Section 814(d) of the Resolution as if such institution were acting as co-Trustee under the Resolution; or

(o) to make any other change which, in the judgment of the Trustee, does not materially adversely affect the interests of the Bondowners.

**Supplements and Amendments Requiring Consent of Owners of a Majority in Principal Amount of Bonds (Section 1002)**

Subject to the terms and provisions contained in Section 1002 of the Resolution, and not otherwise, (i) the owners of not less than fifty-one per centum (51%) in aggregate principal amount of the Bonds then Outstanding; and (ii) if less than all of the Bonds then Outstanding are affected, the owners of not less than fifty-one per centum (51%) in principal amount of Bonds so affected then Outstanding, shall have the right, from time to time, anything contained in the Resolution to the contrary *notwithstanding*, to consent to and approve the adoption by the Department and the Trustee of such resolution or resolutions supplemental to the Resolution as shall be deemed necessary or desirable by the Department for the purpose of modifying, altering, amending, adding to, repealing or rescinding, in any particular, any of the terms or provisions contained in the Resolution or in any Supplemental Resolution. Notwithstanding the foregoing, nothing in the Resolution contained shall permit, or be construed as permitting, without the consent of all materially adversely affected Bondowners, (a) any change in the terms of redemption or of the maturity of the principal of or the interest on any Bond issued under the Resolution; or (b) a reduction in the principal amount of any Bond or the redemption premium or the rate of interest thereon; or (c) the creation of a lien upon or a pledge of the Pledged Property, or any part thereof, other than the lien and pledge created or permitted by the Resolution; or (d) a preference or priority of any Bond or Bonds over any other Bond or Bonds, except as may be permitted by the applicable Series Resolution(s); or (e) a reduction in the aggregate principal amount or classes of the Bonds required for consent to such Supplemental Resolution; or (f) an amendment or modification of the rights or obligations of the Trustee without the written consent of the Trustee. Nothing in the Resolution contained, however, shall be construed as making necessary the approval by Bondowners of the execution of any Supplemental Resolution as authorized in Section 1001 of Article X of the Resolution. If any such modification or amendment will, by its terms, not take effect so long as any Bonds of any specified like Series and maturity remain Outstanding, the consent of the owners of such Bonds shall not be required and such Bonds shall not be deemed to be Outstanding for the purpose of any calculation of Outstanding Bonds under Section 1002 of the Resolution. For the purpose of Section 1002 of the Resolution, a Series shall be deemed to be affected by a modification or amendment of the Resolution or a Supplemental Resolution if the same adversely affects or diminishes the rights of the owner of Bonds of such Series. The Trustee may in its discretion determine whether or not in accordance with the foregoing powers of amendment, Bonds of any particular Series and maturity would be affected by any modification or amendment of the Resolution or a Supplemental Resolution and any such determination shall be binding and conclusive on the Department and all owners of Bonds.

Whenever, at any time within one year after the date of the first giving of such notice, the Department shall deliver to the Trustee an instrument or instruments in writing purporting to be executed by the owners of not less than fifty-one per centum (51%) in aggregate principal amount of the affected Bonds then Outstanding, which instrument or instruments shall refer to the proposed Supplemental Resolution described in such notice and shall specifically consent to and approve the execution thereof in substantially the form of the copy thereof referred to in such

notice, thereupon, but not otherwise, the Trustee may perform its duties under such Supplemental Resolution in substantially such form, without liability or responsibility to any Bondowner, whether or not such Bondowner shall have consented thereto.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds, the 2001 Series A Bonds, and the 2002 Series A Bonds) Outstanding under the Resolution, the Insurer will be deemed to be the owner of the 1998 Series A Bonds, the 2001 Series A Bonds, and the 2002 Series A Bonds.

### **Defeasance (Section 1101)**

If, when the Bonds secured by the Resolution shall have become due and payable in accordance with their terms or otherwise as provided in the Resolution, or shall have been duly called for redemption or irrevocable instructions to call the Bonds for redemption shall have been given by the Department to the Trustee and (a) the whole amount of the principal of, Redemption Price and the interest on all of such Bonds shall be paid; or (b) the Trustee shall hold money or Government Obligations or shall hold money and Government Obligations, sufficient to pay the principal of, Redemption Price and interest on all Outstanding Bonds on their respective interest payment, stated maturity or prescribed redemption dates, provided that such Government Obligations shall be in such amount that the principal of and the interest on such Government Obligations so held by the Trustee, when due and payable, will provide sufficient money which, with any and all other money held by the Trustee for such purpose under the provisions of the Resolution, shall be sufficient to pay such principal of, Redemption Price, and the interest on such Bonds and, if sufficient funds shall also have been provided for paying all other obligations payable under the Resolution by the Department, then and in that case the right, title and interest of the Trustee under the Resolution shall thereupon cease, terminate and become void, and the Trustee in such case, on demand of the Department, shall release the Resolution and shall release the security, and shall execute such documents to evidence such release as may be reasonably required by the Department, and shall turn over to the Department or to such officer, board, or body as may then be entitled to receive the same, all the remaining property held by the Trustee under the Resolution. Otherwise, the Resolution shall be, continue and remain in full force and effect; *provided, however*, that in the event money or Government Obligations shall be deposited with and held by the Trustee as provided in the Resolution, applicable provisions of the Resolution, particularly Articles II, III, VII and XI, pertaining to the payment of the principal and Redemption Price of, or interest on the Bonds issued under the Resolution and other obligations payable under the Resolution by the Department, shall be continued in force until such Bonds and other obligations have been fully paid.

## **TAX MATTERS**

### **Federal Tax Matters**

The Offered Revenue Bonds and the 2005 G.O. Bonds are considered a single issue for certain Federal income tax purposes. The requirements of applicable Federal tax law must be satisfied with respect to the Offered Revenue Bonds in order that interest on the Offered Revenue Bonds not be included in gross income for Federal income tax purposes retroactive to

the date of issuance thereof. The Offered Revenue Bonds are treated for Federal income tax purposes as refunding certain existing pre-Ullman bonds issued to finance the Program. The moneys which will be made available from the issuance of the Offered Revenue Bonds to finance Contracts of Purchase will be Unrestricted Moneys. The loan eligibility requirements described in APPENDIX F – “CERTAIN FEDERAL TAX CODE REQUIREMENTS” do not apply to Unrestricted Moneys. These requirements also do not apply to the Contracts of Purchase to be allocated to the Offered Revenue Bonds for Federal income tax purposes following payment of the bonds being refunded by the Offered Revenue Bonds. The Federal Tax Code establishes other requirements described below which will apply to the Offered Revenue Bonds. Proceeds of the Offered Revenue Bonds must be used to retire outstanding bonds within ninety days of their date of issuance. Failure to so use all of such proceeds and to comply with other requirements of the Federal Tax Code with respect to the Offered Revenue Bonds could cause interest on the Offered Revenue Bonds to be included in gross income for Federal income tax purposes retroactive to their date of issuance.

#### ***Requirements Imposed on the Offered Revenue Bonds***

The first general requirement of the Federal Tax Code applicable to the Offered Revenue Bonds is that the aggregate amount of private activity bonds (exclusive of qualified veterans' mortgage bonds) that may be issued by the Department in any calendar year (or previous years' carried forward amount) must not exceed the portion of the private activity bond volume limit for the State for such calendar year that is allocated by the State to the Department. The Offered Revenue Bonds are within the applicable limit for the Department.

The Federal Tax Code requires that the effective interest rate on Contracts of Purchase financed with the lendable proceeds of qualified mortgage bonds and qualified veterans' mortgage bonds may not exceed the yield on the issue by more than 1.125% (1.50% for pre-Ullman bonds such as the Offered Revenue Bonds) (see “Other Requirements Imposed by the Federal Tax Code – Yield Limitations and Rebate” in APPENDIX F), and that certain investment earnings on non-mortgage investments, calculated based upon the extent such investment earnings exceed the amount that would have been earned on such investments if the investments were invested at a yield equal to the yield on the issue, be rebated to the United States. The Department has covenanted to comply with these requirements and has established procedures to determine the amount of excess earnings, if any, that must be rebated to the United States or to veterans. See “SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS – The 1943 Fund” and “THE PROGRAM – Contracts of Purchase” for discussions of provisions of the Veterans Code which affect the Department's ability to establish and to change interest rates on Contracts of Purchase.

The Department has covenanted in the Resolution to do and perform all acts and things permitted by law and necessary or desirable to assure that interest paid on the Offered Revenue Bonds shall not be included in gross income for Federal income tax purposes.

#### ***Opinion of Bond Counsel to the Department***

In the opinion of Hawkins Delafield & Wood LLP, Bond Counsel to the Department to the Department, under existing statutes and court decisions and assuming continuing compliance

by the Department with certain tax covenants described herein, (i) interest on the Offered Revenue Bonds is excluded from gross income for Federal income tax purposes pursuant to Section 103 of the Internal Revenue Code of 1986, as amended (the “Code”); and (ii) interest on the Offered Revenue Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, *however*, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations. In rendering its opinion, Bond Counsel to the Department has relied on certain representations, certifications of fact, and statements of reasonable expectations made by the Department in connection with the Offered Revenue Bonds, and Bond Counsel to the Department has assumed compliance by the Department with certain ongoing covenants to comply with applicable requirements of the Code to assure the exclusion of interest on the Offered Revenue Bonds from gross income under Section 103 of the Code.

Bond Counsel to the Department expresses no opinion regarding any other Federal or, except as stated below under “State Tax Matters,” state tax consequences with respect to the Offered Revenue Bonds. Bond Counsel to the Department renders its opinion under existing statutes and court decisions as of the issue date, and assumes no obligation to update its opinion after the issue date to reflect any future action, fact or circumstance, or change in law or interpretation, or otherwise. Bond Counsel to the Department expresses no opinion on the effect of any action taken after the date of issuance of the Offered Revenue Bonds, or not taken, in reliance upon an opinion of other counsel on the exclusion from gross income for Federal income tax purposes of interest on the Offered Revenue Bonds, or under state and local tax law.

#### ***Certain Collateral Federal Tax Consequences***

The following is a brief discussion of certain collateral Federal income tax matters with respect to the Offered Revenue Bonds under existing statutes. It does not purport to deal with all aspects of Federal taxation that may be relevant to a particular owner of an Offered Revenue Bond. Prospective investors, particularly those who may be subject to special rules, are advised to consult their own tax advisors regarding the Federal tax consequences of owning and disposing of the Offered Revenue Bonds.

As noted above, interest on the Offered Revenue Bonds is not a preference item in determining the tax liability of individuals, corporations, and other taxpayers subject to the alternative minimum tax imposed by Section 55 of the Code. Interest on the Offered Revenue Bonds must also be taken into account in determining the tax liability of foreign corporations subject to the branch profits tax imposed by Section 884 of the Code.

Prospective owners of the Offered Revenue Bonds should be aware that the ownership of such obligations may result in collateral Federal income tax consequences to various categories of persons, such as corporations (including S corporations and certain foreign corporations), financial institutions, property and casualty insurance companies, individual recipients of Social Security or Railroad Retirement benefits, individuals otherwise eligible for the earned income tax credit and to taxpayers deemed to have incurred or continued indebtedness to purchase or carry obligations the interest on which is not included in gross income for Federal income tax purposes. Interest on the Offered Revenue Bonds may be taken into account in determining the

tax liability of foreign corporations subject to the branch profits tax imposed by Section 884 of the Code.

Legislation affecting municipal bonds is frequently considered by the United States Congress. There can be no assurance that legislation enacted or proposed after the date of issuance of the Offered Revenue Bonds will not have an adverse effect on the tax-exempt status or market price of the Offered Revenue Bonds.

### **State Tax Matters**

Bond Counsel to the Department is of the opinion that, under existing law, the interest on the Offered Revenue Bonds is exempt from personal income taxes of the State. A complete copy of the proposed form of opinion to be rendered with respect to the Offered Revenue Bonds is contained in APPENDIX E.

## **LITIGATION**

### **No Material Litigation**

At the time of the delivery of and payment for the Offered Revenue Bonds, the Department shall deliver, or cause to be delivered (1) a certificate of the Attorney General of the State to the effect that, except as described in this Official Statement, to his knowledge, no material litigation is pending (with service of process having been accomplished) or, to his knowledge, threatened seeking to restrain or enjoin the sale, issuance or delivery of any of the Offered Revenue Bonds or undertaking of any activities which the Department has undertaken or will undertake pursuant to the Purchase Contract with respect to the Offered Revenue Bonds, or contesting any authorization for, or the validity of, the Offered Revenue Bonds, the Resolution, such Purchase Contract or the Contracts of Purchase; and that, with respect to the officers who executed the Offered Revenue Bonds on behalf of the Department, to his knowledge, challenging the entitlement of said officers to their respective offices; and (2) an opinion of Chief Counsel to the Department to the effect that, other than as described in the following paragraphs, there is no action, suit or proceeding pending (with service of process having been accomplished) or, to his knowledge, threatened against the Department involving any of the property or assets of the 1943 Fund, the Bond Reserve Account or the Loan Loss Account that involves the possibility of any judgment or uninsured liability which may result in any material adverse change in the business, properties or assets or in the condition, financial or otherwise, of the 1943 Fund, the Bond Reserve Account or the Loan Loss Account; and that, with respect to the officers who executed the Offered Revenue Bonds on behalf of the Department, to the best of his knowledge, the title of said officers to their respective offices is not being contested or questioned.

## **UNDERWRITING**

The Offered Revenue Bonds are being purchased by the underwriters listed on the cover page hereof (together, the "Underwriters"). The Underwriters have jointly and severally agreed to purchase the Offered Revenue Bonds for a purchase price of the aggregate principal amount thereof. In connection therewith the Department will pay a fee to the Underwriters of

\$430,055.50. The initial public offering prices of the Offered Revenue Bonds may be changed from time to time by the Underwriters.

The Purchase Contract relating to the Offered Revenue Bonds provides that (i) the Underwriters will purchase all of the Offered Revenue Bonds if any of the Offered Revenue Bonds are purchased and (ii) the obligation to make such purchase is subject to certain terms and conditions set forth in such purchase contract including, among others, the approval of certain legal matters by counsel.

### **CERTAIN LEGAL MATTERS**

Legal matters incident to the authorization, issuance, sale and delivery of the Offered Revenue Bonds to the Underwriters are subject to the approval of The Honorable Bill Lockyer, Attorney General of the State, and of Hawkins Delafield & Wood LLP, Bond Counsel to the Department to the Department. The issuance and acceptance of the Offered Revenue Bonds are conditioned upon delivery by Bond Counsel to the Department of the applicable approving opinion in substantially the applicable form set forth in APPENDIX E hereto and by the Attorney General of the applicable approving opinion in substantially the applicable form set forth in APPENDIX F hereto. Certain legal matters will be passed upon by Quateman & Zidell LLP, Disclosure Counsel to the State. Certain legal matters will be passed upon for the Underwriters by their counsel, Kutak Rock LLP.

### **INDEPENDENT AUDITORS**

The financial statements of the 1943 Fund and the Veterans Debenture Revenue Fund as of and for the years ended June 30, 2004 and June 30, 2003, included in APPENDICES A and B to this Official Statement have been audited by Deloitte & Touche LLP, independent auditors, as stated in their reports.

### **LEGALITY FOR INVESTMENT**

The Act provides that the Offered Revenue Bonds shall be legal investments in California for all trust funds, funds of all insurance companies, banks (both commercial and savings), trust companies, state school funds, and pension funds, public or private. The Act also provides that any money or funds which may by law be invested in bonds of the State may be invested in the Offered Revenue Bonds and that whenever any bonds of the State may by law be used as security for the performance of any act or the deposit of any public money, the Offered Revenue Bonds may be so used.

### **FORWARD-LOOKING STATEMENTS**

The statements contained in this Official Statement which includes the Appendices hereto, and in any other information provided by the Department, that are not purely historical, are forward-looking statements, including statements regarding the Department's expectations, hopes, intentions or strategies regarding the future. Prospective investors should not place undue reliance on forward-looking statements. All forward-looking statements included in this Official

Statement are based on information available to the Department on the date hereof, and the Department assume no obligation to update any such forward-looking statements. It is important to note that the Department's actual results could differ materially from those in such forward-looking statements.

The forward-looking statements herein are necessarily based on various assumptions and estimates and are inherently subject to various risks and uncertainties, including risks and uncertainties relating to the possible invalidity of the underlying assumptions and estimates and possible changes or developments in social, economic, business, industry, market, legal and regulatory circumstances and conditions and actions taken or omitted to be taken by third parties, and legislative, judicial and other governmental authorities and officials. Assumptions related to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond the control of the Department. Any of such assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Official Statement would prove to be accurate.

## **RATINGS**

S&P, Moody's and Fitch have assigned ratings of "AA-", "Aa2" and "AA-" to the Offered Revenue Bonds.

An explanation of the significance and status of such credit ratings may be obtained from the rating agencies furnishing the same. There is no assurance that such ratings will continue for any given period of time or that they will not be revised or withdrawn entirely by any such rating agencies, if in their respective judgments, circumstances so warrant. A revision or withdrawal of any such credit rating could have an effect on the market price of the Offered Revenue Bonds.

## **CONTINUING DISCLOSURE**

The Department has covenanted in a Master Continuing Disclosure Undertaking (the "Master Continuing Disclosure Undertaking"), for the benefit of the Bondowners and Beneficial Owners (each as defined in Exhibit D) of the Offered Revenue Bonds, to provide certain financial information and operating data relating to the Department (the "Annual Financial Information") by not later than the first day of the tenth calendar month following the end of the Department's then-current fiscal reporting period, commencing with the reporting period ended June 30, 1997, and to provide notices of the occurrence of certain enumerated events if material. The Master Continuing Disclosure Undertaking requires that the Annual financial Information be filed by the Department with the Trustee, with the State information repository (the "SID"), if any, and with each nationally recognized municipal securities information repository (each, a "NRMSIR"). The Master Continuing Disclosure Undertaking requires that notices of material events be filed by the Department with the Trustee, with the SID and with either of each NRMSIR or the Municipal Securities Rulemaking Board. The specific nature of the information to be contained in the Annual financial Information or the notices of material events is summarized in Exhibit D – "SUMMARY OF CERTAIN PROVISIONS OF THE MASTER CONTINUING DISCLOSURE UNDERTAKING." These covenants have been made in order

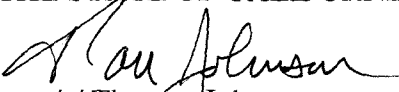


to assist the Underwriters in complying with Rule 15c2-12(b)(5) promulgated by the Securities and Exchange Commission (the "Rule"). The Department has never failed to comply in all material respects with any previous undertakings with respect to the Rule to provide annual financial information or notices of material events.

### MISCELLANEOUS

The information set forth herein is subject to change without notice and no implication should be derived therefrom or from the sale of the Offered Revenue Bonds that there has been no change in the affairs of the Department after the date hereof. The distribution of this Official Statement has been duly authorized by the Department. Any statement in this Official Statement involving matters of opinion, whether or not expressly so stated, is intended as such, and not as a representation of fact. Concurrently with the delivery of the Offered Revenue Bonds, the Department will furnish a certificate to the effect that this Official Statement, as of its date and as of the date of delivery of the Offered Revenue Bonds, does not and will not contain any untrue statement of a material fact or omit to state any material fact necessary to make the statements herein, in the light of the circumstances under which they were made, not misleading. The agreement of the Department with the holders of the Offered Revenue Bonds is set forth in the Resolution. This Official Statement is not to be construed as an agreement or contract between the Department and the purchaser or holder of any of the Offered Revenue Bonds. Additional information may be obtained from the Department at 1227 "O" Street, Sacramento, California 95814, Attention: Bond Finance Division.

DEPARTMENT OF VETERANS AFFAIRS  
OF THE STATE OF CALIFORNIA

By:   
/s/ Thomas Johnson  
Secretary

Dated: April 12, 2005

to assist the Underwriters in complying with Rule 15c2-12(b)(5) promulgated by the Securities and Exchange Commission (the "Rule"). The Department has never failed to comply in all material respects with any previous undertakings with respect to the Rule to provide annual financial information or notices of material events.

### **MISCELLANEOUS**

The information set forth herein is subject to change without notice and no implication should be derived therefrom or from the sale of the Offered Revenue Bonds that there has been no change in the affairs of the Department after the date hereof. The distribution of this Official Statement has been duly authorized by the Department. Any statement in this Official Statement involving matters of opinion, whether or not expressly so stated, is intended as such, and not as a representation of fact. Concurrently with the delivery of the Offered Revenue Bonds, the Department will furnish a certificate to the effect that this Official Statement, as of its date and as of the date of delivery of the Offered Revenue Bonds, does not and will not contain any untrue statement of a material fact or omit to state any material fact necessary to make the statements herein, in the light of the circumstances under which they were made, not misleading. The agreement of the Department with the holders of the Offered Revenue Bonds is set forth in the Resolution. This Official Statement is not to be construed as an agreement or contract between the Department and the purchaser or holder of any of the Offered Revenue Bonds. Additional information may be obtained from the Department at 1227 "O" Street, Sacramento, California 95814, Attention: Bond Finance Division.

### **DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA**

By: /s/ Thomas Johnson  
Secretary

Dated: April 12, 2005

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**APPENDIX A-1**

**FINANCIAL STATEMENTS OF THE 1943 FUND  
FOR FISCAL YEARS 2004 AND 2003  
AND INDEPENDENT AUDITOR'S REPORT**

***Veterans Farm And Home  
Building Fund Of 1943,  
Department Of Veterans  
Affairs, State Of California***

*Financial Statements for the Years Ended  
June 30, 2004 and 2003 and Independent  
Auditors' Report*

# **VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS**

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## INDEPENDENT AUDITORS' REPORT

California Veterans Board  
State of California  
Sacramento, California

We have audited the accompanying balance sheets of the Veterans Farm and Home Building Fund of 1943, which is administered by the Department of Veterans Affairs of the State of California (the "Department") as of June 30, 2004 and 2003, and the related statements of revenues, expenses and changes in fund equity and of cash flows for the years then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Veterans Farm and Home Building Fund of 1943, and are not intended to present the financial position of the Department of Veterans Affairs of the State of California or the results of its operations and cash flows of its proprietary funds.

In our opinion, such financial statements referred to above present fairly, in all material respects, the financial position of the Veterans Farm and Home Building Fund of 1943, Department of Veterans Affairs of the State of California as of June 30, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America

Management's Discussion and Analysis on pages 2 through 5 is not a required part of the financial statements, but is supplementary information required by the GASB. This supplementary information is the responsibility of the Department's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and we do not express an opinion on it.

*Deloitte + Touche LLP*

October 12, 2004

## Management's Discussion and Analysis of Financial Position and Results of Operations

The Department of Veterans Affairs (the "Department") began making low interest rate farm and home financing available to veterans after World War I, following the enactment by the California Legislature of the Veterans Farm and Home Purchase Act of 1921 (the "Cal-Vet Farm and Home Program" or the "Program"). In 1943, the Legislature enacted the Veterans Farm and Home Purchase Act of 1943 which modified the Program to meet new needs of California's veterans. The 1943 Act established the 1943 Fund in the State Treasury and the Department established the Veterans Farm and Home Building Fund of 1943 (the "Fund"), which is the principal fund utilized for the Cal-Vet Farm and Home Loan Program. Financing is provided as installment loans, which are referred to as Contracts of Purchase.

The sales of the Fund's Home Purchase Revenue Bonds and Veterans General Obligations Bonds combined with monies received from prepayments of Contracts of Purchase and other revenues under the Program not needed at any given time to meet the then current bond retirement schedules and operating costs have financed the purchase of farms and homes since the Program's inception. Expenditures are primarily for debt service and administration of the Program.

The enclosed financial statements present the Fund's balance sheets, statements of revenues, expenses and changes in fund equity and cash flows. The following is a condensed summary of financial information for the years ended June 30, 2004 and 2003, respectively.

### Condensed Financial Information (In thousands of dollars)

#### Balance Sheets

Condensed Balance Sheet	2004	2003	% Change
Assets:			
Cash and investments	\$ 753,782	\$ 1,002,343	(24.80)%
Receivables under contracts of purchase—net	1,527,950	1,756,379	(13.01)%
Other receivables and assets	<u>60,656</u>	<u>61,907</u>	(2.02)%
Total	<u>\$2,342,388</u>	<u>\$2,820,629</u>	(16.96)%
Liabilities:			
Bonds payable	\$ 2,039,554	\$ 2,482,695	(17.85)%
Other payables and liabilities	<u>53,505</u>	<u>59,661</u>	(10.32)%
Total	2,093,059	2,542,356	(17.67)%
Fund Equity	<u>249,329</u>	<u>278,273</u>	(10.40)%
Total	<u>\$2,342,388</u>	<u>\$2,820,629</u>	(16.96)%



Total assets decreased \$478.2 million from \$2.82 billion at June 30, 2003 to \$2.34 billion at June 30, 2004. This decrease consisted primarily of the following items:

Total cash and investments decreased \$246 million from \$1 billion at June 30, 2003 to \$754 million at June 30, 2004. This decrease is the direct result that the Department used excess cash to redeem bonds.

Net receivables under contracts of sale decreased \$228.4 million from \$1.8 billion at June 30, 2003 to \$1.5 billion at June 30, 2004. This decrease is principally the result of the current low interest rate environment. During the fiscal year, many contract holders refinanced their loans to lower interest rates with other financial institutions.

All other assets decreased \$1.2 million from \$61.9 million at June 30, 2003 to \$60.7 million at June 30, 2004. This net decrease was primarily due to a reduction in the inventory of repossessed properties, a decrease in interest receivables brought about by the increased prepayments of higher yielding Contracts of Sale rates into lower yielding investments and a one time positive adjustment of \$6.4 million from the Life and Disability Program. Without the one time adjustment all other assets decreased \$7.7 million over the prior fiscal year.

Bonds payable and other payables and liabilities decreased \$449.0 million from \$2.54 billion at June 30, 2003 to \$2.09 billion at June 30, 2004. This net decrease is primarily the result of the early redemption of bonds using excess cash.

Fund equity decreased by \$29 million from \$278.3 million at June 30, 2003 to \$249.3 million at June 30, 2004 as a result of the excess of expenses over revenues of \$29 million.

The total asset to liability ratio for the Fund was at 1.12 at June 30, 2004 and 1.11 at June 30, 2003.

Revenues, Expenses and Changes in Fund Equity

**Condensed Statements of Revenues, Expenses and Changes in Fund Equity**

	<b>2004</b>	<b>2003</b>	<b>% Change</b>
<b>PROGRAM OPERATIONS:</b>			
Interest revenues:			
Contracts of purchase	\$ 100,676	\$ 140,036	(28.11)%
Investments and other	<u>25,837</u>	<u>36,703</u>	(29.61)%
Total program operating revenues	126,513	176,739	(28.42)%
Expenses:			
Interest expense	145,046	174,969	(17.10)%
Other expenses	<u>(1,993)</u>	<u>(5,375)</u>	(62.92)%
Total program operating expenses	<u>143,053</u>	<u>169,594</u>	(15.65)%
(Deficiency) excess of program operations revenue (under) over program operations expense	<u>(16,540)</u>	<u>7,145</u>	(331.49)%
<b>PROGRAM ADMINISTRATION:</b>			
Total program administration revenues	7,138	3,924	81.91 %
Total program administration expenses	<u>20,715</u>	<u>28,809</u>	(28.10)%
Excess of program administration revenue over program administration expense	<u>(13,577)</u>	<u>(24,885)</u>	(45.44)%
Gain on sale of repossessed property	<u>1,173</u>	<u>2,092</u>	(43.93)%
Deficiency of revenues over expenses	<u>\$ (28,944)</u>	<u>\$ (15,648)</u>	84.97 %

**Program Operations**

Interest revenue from Contracts of Purchase decreased by \$39.4 million from \$140.0 million for the year ended June 30, 2003 to \$100.6 million for the year ended June 30, 2004, principally due to the decline of the Program's loan portfolio.

Interest revenues on investments decreased by \$10.9 million from \$36.7 million for the year ended June 30, 2003 to \$25.8 million for the year ended June 30, 2004. This decrease is due to the current historically low interest rates of the State's Surplus Money Investment Fund ("SMIF"), in which a majority of the program's cash is invested. Additionally, cash balances decreased due to early redemption of bonds.

Interest expense decreased by \$30 million from \$175 million for the year ended June 30, 2003 to \$145 million for the year ended June 30, 2004. The decrease is due to the significant reduction of outstanding bonds as a result of early redemptions of bonds. In addition, the Department refunded

\$124 million of bonds from higher yielding long term fixed rate to lower yielding variable rate bonds.

Program operation revenues for the fiscal year are deficient by \$16.5 million compared to an excess of \$7.1 million for the prior fiscal year. The decrease of \$23.6 million is due to high contract prepayments and refinancing activities, which resulted in a shift of assets from higher yielding contracts of purchase to lower yielding short term SMIF investments. The other contributing factor is the interest expense from the \$460 million of high yield, non-callable bonds which could not be reduced from bond redemptions due to its non-callable nature.

#### **Program Administration**

Program administration revenues include loan origination fees paid to the Department, loan guarantee fees collected by the Department to be applied, in part, to the purchase of private mortgage insurance, other miscellaneous fees collected from program participants, rental income, and certain reimbursements of prior expenses, among others. Revenues increased by \$3.2 million from \$3.9 million for the year ended June 30, 2003 to \$7.1 million for the year ended June 30, 2004. The increase is mainly the result of fees collected from higher volume of loan originations.

Total program administration expenses decreased \$8.1 million from \$28.8 million for the year ended June 30, 2003 to \$20.7 million for the year ended June 30, 2004. The decrease is due to three factors: (1) Payroll and related expenses decreased by \$0.7 million as the Department cut staff levels, (2) General and administrative expenses decreased by \$1.7 million as many of the Department's cost control measures took effect and (3) The Self-Insured Life and Disability program produced a profit of \$4.2 million for the fiscal year as compared to a loss of \$1.6 million for the prior fiscal year. This program improvement is principally due to a one-time refund of \$6.0 million from the insurance company, Pacific Life and Annuity.

Gain on Sale of Repossessed Properties decreased \$0.92 million from the last fiscal year. This decrease is due to reduced sales of repossessed properties as the Department's holdings of these properties went from \$5.2 million as of June 30, 2003 to \$2.5 million as of June 30, 2004.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**BALANCE SHEETS  
JUNE 30, 2004 AND 2003 (in thousands)**

	<b>2004</b>	<b>2003</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents:		
Cash In State Treasury	\$ 9,756	\$ 12,660
State of California's Surplus Money Investment Fund	<u>582,286</u>	<u>722,238</u>
Total cash and cash equivalents	592,042	734,898
Receivables under contracts of purchase, net of allowance for uncollectible contracts of \$8,540 in 2004 and \$10,040 in 2003	1,527,950	1,756,379
Interest receivable:		
Contracts of purchase	7,446	10,076
State of California's Surplus Money Investment Fund	2,272	3,141
Other investments	<u>786</u>	<u>1,300</u>
Total current assets	<u>2,130,496</u>	<u>2,505,794</u>
<b>Noncurrent assets:</b>		
Investments:		
Guaranteed investment contracts	154,890	265,595
Insurance administrators	<u>6,850</u>	<u>1,850</u>
Total investments	161,740	267,445
Due from Veterans Debenture Revenue Fund	37,532	37,411
Other real estate owned, net of allowance for losses of \$527 in 2004 and \$1,020 in 2003	2,460	5,228
Land, improvements and equipment—net of accumulated depreciation of \$12,713 in 2004 and \$11,732 in 2003	3,398	4,372
Other	<u>6,762</u>	<u>379</u>
Total noncurrent assets	<u>211,892</u>	<u>314,835</u>
<b>TOTAL</b>	<b><u>\$2,342,388</u></b>	<b><u>\$2,820,629</u></b>
<b>LIABILITIES AND FUND EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Bonds payable—current portion	\$ 229,650	\$ 156,205
Accrued interest and other liabilities	33,209	37,439
Due to other funds	<u>847</u>	<u>287</u>
Total current liabilities	263,706	193,931
<b>Noncurrent liabilities:</b>		
Bonds payable—noncurrent portion	1,809,904	2,326,490
Insurance claims payable and loss reserves	<u>19,449</u>	<u>21,935</u>
Total noncurrent liabilities	<u>1,829,353</u>	<u>2,348,425</u>
Total liabilities	2,093,059	2,542,356
<b>FUND EQUITY—Unrestricted</b>	<u>249,329</u>	<u>278,273</u>
<b>TOTAL</b>	<b><u>\$2,342,388</u></b>	<b><u>\$2,820,629</u></b>

See notes to financial statements.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN FUND EQUITY  
YEARS ENDED JUNE 30, 2004 AND 2003 (in thousands)**

	<b>2004</b>	<b>2003</b>
<b>PROGRAM OPERATIONS:</b>		
Interest revenues:		
Contracts of purchase of properties	\$ 100,676	\$ 140,036
Investments and other	23,828	34,674
Transfers of revenue from Veterans Debenture Revenue Fund	<u>2,009</u>	<u>2,029</u>
Total program operations revenues	<u>126,513</u>	<u>176,739</u>
Expenses:		
Interest expense	145,046	174,969
Reversal of allowance for uncollectible contracts	<u>(1,993)</u>	<u>(5,375)</u>
Total program operations expenses	<u>143,053</u>	<u>169,594</u>
Excess (deficiency) of program operations revenues over program operations expenses	<u>(16,540)</u>	<u>7,145</u>
<b>PROGRAM ADMINISTRATION:</b>		
Revenues:		
Loan fees	6,669	3,625
Other income	1,298	2,188
Deficiency of amounts charged to contract holders over fire and hazard insurance claims and expenses and changes in insurance reserves	<u>(829)</u>	<u>(1,889)</u>
Total program administration revenues	<u>7,138</u>	<u>3,924</u>
Expenses:		
Payroll and related costs	13,050	13,660
General and administrative expenses	11,859	13,581
(Excess) deficiency of self-insured life and disability insurance claims and expenses and changes in insurance reserves over amounts charged to contract holders	<u>(4,194)</u>	<u>1,568</u>
Total program administration expenses	<u>20,715</u>	<u>28,809</u>
Excess of program administration expenses over program administration revenues	<u>(13,577)</u>	<u>(24,885)</u>
<b>NONOPERATING REVENUE—Gain on sale of repossessed property</b>	<u>1,173</u>	<u>2,092</u>
Excess (deficiency) of revenues over (under) expenses	(28,944)	(15,648)
<b>FUND EQUITY:</b>		
Beginning of year	<u>278,273</u>	<u>293,921</u>
End of year	<u>\$ 249,329</u>	<u>\$ 278,273</u>

See notes to financial statements.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**STATEMENTS OF CASH FLOWS**

**YEARS ENDED JUNE 30, 2004 AND 2003 (in thousands)**

	<b>2004</b>	<b>2003</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Receipts from contractholders	\$ 13,211	\$ 11,995
Interest received	130,775	182,842
Interest payments	(140,292)	(174,601)
Payments to suppliers and employees	(13,110)	(43,462)
Other (payments) receipts	(16,862)	6,322
Net cash used for operating activities	<u>(26,278)</u>	<u>(16,904)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Net decrease in receivables under contracts of purchase	229,929	589,636
Net decrease in investment securities	105,705	107,965
Purchase of land, improvements and equipment	(7)	(71)
Net cash provided by investing activities	<u>335,627</u>	<u>697,530</u>
<b>CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:</b>		
Proceeds from sales of bonds	124,635	-
Maturities of bonds payable	(74,490)	(72,315)
Early redemption of bonds payable	(483,380)	(321,665)
Net decrease in Due from Veterans Debenture Revenue Fund	(121)	(65)
Additions to deferred financing costs	(779)	-
Additions to commercial paper from maturities of bonds payable	(18,070)	(66,735)
Net cash used for noncapital financing activities	<u>(452,205)</u>	<u>(460,780)</u>
(DECREASE) INCREASE IN CASH IN STATE TREASURY	(142,856)	219,846
<b>CASH IN STATE TREASURY:</b>		
Beginning of year	<u>734,898</u>	<u>515,052</u>
End of year	<u>\$ 592,042</u>	<u>\$ 734,898</u>
<b>RECONCILIATION OF OPERATING INCOME TO NET CASH USED BY OPERATING ACTIVITIES:</b>		
Deficiency of revenues under expenses	\$ (28,944)	\$ (15,648)
Adjustments to reconcile to net cash used by operating activities:		
Bond amortization	8,164	5,826
Reversal of allowance for uncollectible contracts	(1,993)	(5,375)
Depreciation	981	1,260
Gain on sale of repossessed property	(1,173)	(2,092)
Effect of changes in assets and liabilities:		
Interest receivable - State of California's Surplus		
Increase in Money Investment Fund	869	901
Increase in interest receivable—other investments	514	461
Increase in interest receivable—contracts of purchase	2,630	4,741
Increase in other real estate owned	5,213	5,387
(Decrease) increase in other assets	(6,383)	180
Decrease in accrued interest and other liabilities	(4,229)	(7,214)
Increase (decrease) in due to other funds	559	(2,557)
Increase in insurance claims payable and loss reserves	(2,486)	(2,774)
<b>NET CASH USED BY OPERATING ACTIVITIES</b>	<u>\$ (26,278)</u>	<u>\$ (16,904)</u>

See notes to financial statements.

# VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

## NOTES TO FINANCIAL STATEMENTS YEARS ENDED JUNE 30, 2004 AND 2003

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### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Organization and Description**—The California Department of Veterans Affairs (the “Department”) is a separate legal entity and a Cabinet level agency of the State of California. A seven-member California Veterans Board (the Board) has policy oversight of the operations of the Department, all of whom are appointed by the Governor, subject to confirmation by the State Senate. The Veterans Farm and Home Building Fund of 1943 (the Fund) was established under the authority of the California Constitution to provide low-interest, long-term farm and home mortgage loan contracts to veterans living in California. The contract loan program has been continuous since 1922. Proceeds from the sale of general obligation bonds, periodically authorized by the vote of the people of California, and revenue bonds authorized by the Legislature are used for contract loans to veterans. Expenses are primarily for debt service and administration of the program. The Fund is tax exempt.

The financial statements represent only the activities of the Veterans Farm and Home Building Fund of 1943, and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary funds. The financial statements of the Fund are included in the financial statements of the State of California as the State represents the primary government and has ultimate oversight responsibility for the Fund.

**Use of Estimates in the Preparation of Financial Statements**—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Basis of Accounting**—The Fund has been classified as a proprietary fund for accounting purposes. Revenues are recorded when earned and expenses are recognized as incurred.

Governmental Accounting Standards Board Statement No. 20 (GASB No. 20), *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Funds Accounting*, established standards for accounting and financial reporting for proprietary funds. In accordance with GASB No. 20, the Fund’s proprietary fund accounting and financial reporting practices are based on all applicable GASB pronouncements as well as the following pronouncements issued on, or before, November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements: Financial Accounting Standards Board (“FASB”) Statements and Interpretations, Accounting Principles Board (“APB”) Opinions, and Accounting Research Bulletins (“ARBs”) of the Committee on Accounting Procedures.

**Investments**—The Department reports all investments at fair value except for certain nonparticipating fixed interest investment contracts which are valued using cost based measures. The fair value of investments is based on published market prices and quotations from major investment brokers and from the State of California for the Surplus Money Investment Fund. Uncommitted bond proceeds for loans to veterans are reflected in the balance sheet within the investments balance.

**Receivables under Contracts of Purchase**—Receivables under contracts of purchase consist of the remaining contract principal balance net of the reserve for uncollectible accounts.

**Allowance for Uncollectible Contracts**—The allowance for uncollectible contracts is established through a provision charged to operations. The allowance is an amount that management believes will be adequate to absorb

losses inherent in existing contracts and commitments to extend credit, based on evaluations of the collectibility and prior loss experience of contracts and commitments to extend credit. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, specific problem contracts, commitments, and current and anticipated economic conditions that may affect the borrowers' ability to repay the obligation.

***Contract Guarantees and Primary Mortgage Insurance***—The Department collects a contract guarantee fee on all contracts with down payments less than 20%. Such contracts are classified as high loan to value ("HLTV") contracts. For eligible borrowers, the fee is used to purchase contract guarantees from the U.S. Department of Veterans Affairs ("USDVA") or primary mortgage insurance. For certain HLTV contracts not eligible for USDVA guarantees, the Fund purchases primary mortgage insurance ("PMI") from Radian Guaranty Inc., formerly, the Commonwealth Mortgage Assurance Company. The PMI provides lifetime coverage on the HLTV contracts, not covered by USDVA guarantees, subject to an aggregate 2% deductible. The Department is responsible for any losses not covered by the USDVA guarantees or the PMI.

***Other Real Estate Owned***—Real estate acquired by repossession is carried at the lower of the contract balance or its net realizable value. After repossession, the value of the underlying contract is written down to the estimated fair value of the real estate, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of any related income, are included in other expenses.

***Insurance Claims Payable and Loss Reserves***—Insurance claims payable and loss reserves include unpaid claims, incurred but not reported claims and loss reserves for the fire and hazard insurance plan and the remaining benefits payable under the Department's former self-insured life and disability protection plan.

***Fire and Hazard Insurance***—This insurance program is provided to eligible contract holders as part of the loan program. The difference between premiums charged to contract holders and claims and expenses incurred and the change in loss reserves is included as a net amount in the statement of revenues, expenses and changes in retained earnings.

***Self-Insured Life and Disability Protection Plan***—Beginning in 1984, the Department operated a self-funded protection plan whereby life and disability insurance was provided to eligible contract holders. This plan was terminated June 1, 1996. The life and disability benefits previously available to these members under the self-insured protection plan continue to be available to those contract holders who were receiving benefits at the time the plan was terminated. Loss reserves to satisfy these obligations of the protection plan which include future disability and life benefits were derived from an actuarial evaluation performed in 2001 that is updated internally on an annual basis. Significant actuarial assumptions and methodologies used to calculate the reserve are interest, mortality, disability, prepayment, and a long-term discount rate of 7%.

***Amortization of Bond Premiums, Discounts and Issuance Costs***—Premiums and discounts arising from the issuance of bonds and expenses incurred in connection with the issuance of bonds are capitalized and amortized using the monthly amortization method, which approximates the interest method.

## **2. CASH AND INVESTMENTS**

Cash in the State Treasury represents amounts held in the Fund's general operating accounts with the State Treasury. These monies are pooled with the monies of other State agencies and invested by the State Treasurer's office. These assets are not individually identifiable.

Investment of bond funds is restricted by applicable California law and the various bond resolutions associated with each issuance, generally, to certain types of investments, including direct obligations of the U.S. Government and its agencies, the State of California's Surplus Money Investment Fund, and investment agreements with financial institutions or insurance companies rated within the top two ratings of a nationally recognized rating service. The investments with the insurance administrator, held as a deposit in accordance with a master agreement for the remaining active life and disability insurance program for disabled contract holders, is authorized by California law.



The Fund's investments in investment agreements totaling \$154,890,000 and \$265,595,000 as of June 30, 2004 and 2003, respectively, are carried at cost. The interest rates on investment agreements are fixed and range from 5.30% to 7.055%. The investment agreements expire from 2005 to 2032.

All of the Fund's investments in U.S. Treasury notes and bonds, corporate bonds, and the amounts administered by the insurance company are categorized as risk category 1, which is defined by GASB Statement No. 3 as investments that are insured or registered or for which the securities are held by the Fund or its agent in the Fund's name. In accordance with GASB Statement No. 3, the Fund's investments held in the State of California's Surplus Money Investment Fund and the investment agreements are not categorized as to risk.

The Fund's investments at June 30, 2004 and 2003 are as follows (in thousands):

	2004	2003
<b>Category 1</b>		
Amounts held in trust fund with insurance administrators	\$ 6,850	\$ 1,850
<b>Investments Not Subject to Categorization</b>		
Investment agreements (at cost)	<u>154,890</u>	<u>265,595</u>
Total	<u>\$ 161,740</u>	<u>\$ 267,445</u>

### 3. RECEIVABLES UNDER CONTRACTS OF PURCHASE

The Fund retains title to all real property subject to contracts of purchase until the contract is satisfied. The veteran's contracts have original terms of 25-30 years and bear interest at rates of 4.25% to 9.75%, depending on the age and type of contract and the classification of the contract holder.

### 4. LAND, IMPROVEMENTS AND EQUIPMENT

As of June 30, land, improvements and equipment consisted of the following:

	2004	2003
Land	\$ 443,531	\$ 443,531
Buildings	12,409,774	12,409,774
Equipment	<u>3,257,564</u>	<u>3,250,630</u>
	16,110,869	16,103,935
Less accumulated appreciation	<u>12,712,764</u>	<u>11,732,344</u>
Land, improvements and equipment, net	<u>\$ 3,398,105</u>	<u>\$ 4,371,591</u>

## 5. BONDS PAYABLE

At June 30, 2004 and 2003, bonds payable included the following (in thousands):

	2004	2003
General obligation bonds of the State of California, annual interest rates from 3.6% to 11.0% due in varying annual installments through 2032 (subject to varying redemption provisions)	\$ 1,433,190	\$ 1,979,685
Home purchase revenue bonds, annual interest rates from 1.37% to 6.15%, due in varying annual installments through 2028 (subject to varying redemption provisions)	<u>617,445</u>	<u>521,475</u>
Total	\$ 2,050,635	\$ 2,501,160
Less—discounts	(617)	(770)
Unamortized bond origination costs	(9,291)	(13,081)
Unamortized bond redemption premiums	<u>(1,173)</u>	<u>(4,614)</u>
Total	2,039,554	2,482,695
Less—current portion	<u>229,650</u>	<u>156,205</u>
Noncurrent portion	<u>\$ 1,809,904</u>	<u>\$ 2,326,490</u>

A summary of debt service requirements for the next five years and to maturity is as follows (in thousands):

Fiscal Year Ending June 30	Principal	Interest
2005	\$ 229,650	\$ 112,684
2006	81,720	104,787
2007	85,690	97,620
2008	91,655	89,694
2009	88,550	81,861
2010-2014	226,865	339,444
2015-2019	447,665	254,672
2020-2024	390,985	144,812
2025-2029	297,530	62,939
2030-2033	<u>110,325</u>	<u>12,505</u>
Total	<u>\$ 2,050,635</u>	<u>\$ 1,301,018</u>

General obligation bonds of the State of California are payable in accordance with the various veterans bond acts by the State General Fund. The full faith and credit of the State of California is pledged for the payment of both principal and interest. All general obligation bonds have an equal claim against the General Fund of the State of California. These bonds are included as obligations of the Fund when the proceeds from bond sales are received. The repayment for the bonds is the responsibility of the Fund. Authorized and unissued bonds under the Veterans Bond Acts of 1996 and 2000 were \$605,585,000 at June 30, 2004 and 2003.

Home Purchase Revenue bonds are special obligations of the Department payable solely from, and by a pledge of, an undivided interest in the assets of the Veterans Farm and Home Building Fund of 1943 and the Veterans Debenture Revenue Fund, a separate fund of the Department. The undivided interest in the net revenues of the 1943 Fund is secondary and subordinate to any interest or right in the 1943 Fund of the people of the State of California and of the holders of general obligation veterans bonds. At any point in time, authorized and unissued revenue bonds equal the \$1.5 billion ceiling authorized in 1987 less revenue bonds outstanding at that time. At June 30, 2004 and 2003, authorized and unissued revenue bonds were \$882,555,000 and \$978,525,000, respectively.

During fiscal year 1998, the Department amended the revenue bond resolution provisions regarding the Bond Reserve Account in the Veterans Debenture Revenue Fund (a separate entity). The revenue bond resolution requires the establishment and maintenance of a Bond Reserve Account in an amount equal to at least three percent of the aggregate outstanding principal amount of all Revenue Bonds with interest rates fixed to maturity. To calculate the reserve requirement, the Ninth Supplemental Resolution established, with respect to the revenue bonds with interest rates fixed to maturity issued pursuant to such resolution (1997 Series A, B and C Bonds, 1998 Series A Bonds, 1999 Series A and B Bonds, 2000 Series A, B and C Bonds, and 2001 Series A Bonds), a requirement equal to at least seven percent of the outstanding principal amount of such Revenue Bonds, and for series 2002 an amount equal to five percent of the outstanding principal amount. Amounts in the Bond Reserve Account shall be used solely for the purposes of paying the principal of and the interest on the Revenue Bonds and for making Mandatory Sinking Fund Account Payments on Revenue Bonds. Amounts on deposit in the Bond Reserve Account as of any date, in excess of the bond reserve requirement, may be transferred out of the Veterans Debenture Revenue Fund to the Fund, at the request of the Department. Investment earnings of the Veterans Debenture Revenue Fund are transferred to the Fund. At June 30, 2004 and 2003, the total assets of the Veterans Debenture Revenue Fund are shown as a receivable of the Fund. Complete financial statements of the Veterans Debenture Revenue Fund, Department of Veterans Affairs, State of California can be obtained by contacting the California Department of Veterans Affairs.

## **6. BOND REFUNDING**

During fiscal year 2004, the Department issued Home Purchase Revenue bonds totaling \$124,635,000 with variable interest rates. The interest rate for the new issue is 1.11% as of June 30, 2004. Bond proceeds from the Home Purchase Revenue bond issues were used to refund previously issued General Obligation bonds of \$124,635,000. The Department did not issue any General Obligation bonds during the fiscal 2004.

## **7. FIRE AND HAZARD INSURANCE**

Fire and hazard insurance coverage is provided on behalf of contract holders for substantially all properties subject to contracts of sale. The program is funded by amounts charged to contract holders which are considered appropriate to cover losses incurred, premiums paid for excess insurance coverage and administration fees. From the amounts charged to contract holders, the Department pays losses up to \$1,500,000 per occurrence or \$12,000,000 per policy year. Coverage in excess of the above amounts is provided under a master policy with an insurance carrier which also administers the program. The loss reserve is based on the third party administrator's estimate of incurred but not reported claims based on the historical trends and loss experience within the portfolio.

The excess of premiums charged to contract holders over claims, expenses and change in loss reserves for the year ended June 30, 2004 and 2003 was as follows (in thousands):

	2004	2003
Amounts charged to contract holders	\$ 6,159	\$ 7,272
(Less) plus:		
(Increase) decrease in estimated loss reserve	(253)	113
Claims loss expense	(5,702)	(7,916)
Master policy premium	(556)	(880)
Administrative fees	<u>(477)</u>	<u>(478)</u>
Deficiency of amounts charged to contract holders over claims and expenses and changes in reserves	<u>\$ (829)</u>	<u>\$ (1,889)</u>

## 8. SELF-INSURED LIFE AND DISABILITY PROTECTION PLAN

The Department was responsible for a self-insured life and disability protection plan for all contract holders until June 1, 1996. Except for existing contract holders receiving benefits at that date, the self-insured life and disability protection plan was replaced by existing life and disability insurance plans provided by commercial insurers.

As of June 30, 2004, the Department remains self-insured for approximately 458 remaining contract holders. Under the provisions of the self-insured plan benefits continue until the beneficiary returns to active employment, dies or their contract is paid off. Loss reserves for these obligations have been actuarially determined.

The excess of claims expenses, changes in loss reserves, and administrative expenses over plan revenues whose coverages continue as obligations of the self-funded life and disability protection plan for the years ended June 30, 2004 and 2003 was as follows (in thousands):

	2004	2003
Claims expenses:		
Life insurance program	\$ (406)	\$ (209)
Disability insurance program	<u>(3,788)</u>	<u>(4,133)</u>
Total claims expenses	☞ (4,194)	☞ (4,342)
Decrease in estimated loss reserves	<u>8,300</u>	<u>2,753</u>
Net claims expenses and change in loss reserves	4,106	(1,589)
Plus plan revenues:		
Life insurance program	46	60
Disability insurance program	<u>93</u>	<u>107</u>
Total	☞ 139	☞ 167
Less administrative fees	<u>(51)</u>	<u>(146)</u>
Excess (deficiency) of plan revenues over (under) net claims expense	<u>\$ 4,194</u>	<u>\$ (1,568)</u>

## 9. COMMITMENTS AND CONTINGENCIES

As of June 30, 2004 and 2003, the Fund had loan commitments to veterans for the purchase of properties under contracts of sale of approximately \$161,681,815 and \$63,965,075, respectively.

The Fund leases several buildings used as district offices. Rent expense for the years ended June 30, 2004 and 2003 was \$349,342 and \$367,976, respectively. Lease terms generally range from five to ten years with options to renew for additional periods. As of June 30, 2004, minimum annual rentals under operating leases are as follows (in thousands):

☞2005	\$ 224
☞2006	209
☞2007	214
☞2008	180
2009	104
2010	<u>54</u>
Total	<u>\$ 985</u>

## 10. RETIREMENT PLAN

**Plan Description** - The Fund contributes to the Public Employees' Retirement Fund ("PERF") as part of the State of California, the primary government. The PERF is a cost-sharing multiple-employer defined benefit pension plan administered by the California Public Employment Retirement System ("CalPERS"). CalPERS provides retirement, death, disability and post retirement health care benefits to members as established by state statute. CalPERS issues a publicly available Comprehensive Annual Financial Report ("CAFR") that includes financial statements and required supplementary information for the Public Employees' Retirement Fund. A copy of that report may be obtained from CalPERS, Central Supply, P.O. Box 942715, Sacramento, CA 95229-2715 or via the internet at [www.calpers.ca.gov](http://www.calpers.ca.gov).

**Funding Policy** - Contributions to the Plan are funded by both the Department and the employee, and are actuarially determined by CalPERS based on covered compensation. State employees, with the exception of employees in the second-tier plan, are required to contribute to the fund. The contribution rates of active plan members are based 5% of compensation in excess of \$513 each month. The employee contribution rate was reduced to zero for fiscal years 2004 and 2003 as part of a bargaining unit contract.

Contributions by the Department to the Plan for the years ended June 30, 2004 and 2003 were approximately \$1,349,000 and \$718,000, or approximately 14.4% and 6.7% of participants' salaries, respectively. No employee contributions were made in fiscal year 2004 and 2003, due to the reduction in the employee contribution rate to zero for fiscal years 2004 and 2003.

**Annual Pension Cost** - For Department's annual pension cost was equal to the Department's required and actual contributions. Required contribution is determined by actuarial valuation using the entry age normal actuarial cost method. The most recent actuarial valuation available is as of June 30, 2001 which actuarial assumptions included (a) 8.25% investment rate of return compounded annually, (b) projected salary increases that vary based on duration of service, and (c) overall payroll growth factor of 3.75% annually. Both (a) and (b) included an inflation component of 3.5% and a .25 percent per annum productivity increase in consumption. The actuarial value of CalPERS assets attributable to the Department was determined using techniques that smooth the effects of short-term volatility in the market value of investments over a two to five-year period.

### *Three-Year Trend Information for the Plan*

Three-Year Fund Trend Information			
Fiscal Year End	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
June 30, 2001	\$ 375,000	100%	\$ -
June 30, 2002	\$ 718,000	100%	\$ -
June 30, 2003	\$ 1,349,000	100%	\$ -

The most recent actuarial valuation of CalPERS indicated that there was an excess of assets over accrued liabilities for benefits due to active and inactive employees and retirees in the plan. The amount of the over funded liability applicable to each agency or department cannot be determined. Trend information, which presents CalPERS progress in accumulating sufficient assets to pay benefits when due is presented in the June 30, 2003 CalPERS CAFR.

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## APPENDIX A-2

### UNAUDITED FINANCIAL STATEMENTS OF THE 1943 FUND FOR THE PERIOD ENDED DECEMBER 31, 2004\*

**Condensed Financial Information:**

(In thousands of dollars)

**Balance Sheets**

Condensed Balance Sheet	Dec-04	Dec-03	% Change
<b>Assets</b>			
Cash and investments	\$ 544,364	\$1,121,235	-51.45%
Receivables under contracts of sale-net	1,527,857	1,561,044	-2.13%
Other receivables and assets	<u>55,259</u>	<u>60,458</u>	-8.60%
<b>Total</b>	<u><u>\$ 2,127,480</u></u>	<u><u>\$2,742,737</u></u>	-22.43%
<b>Liabilities</b>			
Bonds payable	1,836,465	2,425,519	-24.29%
Other payables and liabilities	<u>51,234</u>	<u>57,523</u>	-10.93%
<b>Total</b>	1,887,699	2,483,042	-23.98%
<b>Fund Equity</b>	<u>239,781</u>	<u>259,695</u>	-7.67%
<b>Total</b>	<u><u>\$ 2,127,480</u></u>	<u><u>\$2,742,737</u></u>	-22.43%

\*Un-Audited Financial Statements have been prepared according to applicable GASB rules. Footnotes to the financials and GASB 34 Adjustments are only updated once annually at the end of each fiscal year.

Total assets decreased \$615 million from \$2.74 billion at December 31, 2003 to \$2.13 billion at December 31, 2004.

This decrease consisted primarily of the following items:

Total cash and investments decreased by \$577 million from \$1.1 billion at December 31, 2003 to \$544 million at December 31, 2004.

Net receivables under contracts of sale decreased \$33 million from \$1.56 billion at December 31, 2003 to \$1.53 billion at December 31, 2004. December 2004, \$24.4 million in new loans were originated, payoffs totaled \$26.3 million and monthly principal payments totaled \$5.6 million for a net decrease in the portfolio of \$7.5 million.

All other assets decreased by \$5.2 million from \$60.4 million as of December 31, 2003 to \$55.2 million at December 31, 2004. Accrued interest for loans has decreased \$451 thousand due to the decrease in the loan portfolio, a decrease of \$1.7 million in interest receivable for guaranteed investment agreements/SMIF, a decrease in REO of \$2.1 million due to a decrease in repossessions and increased sales of properties,



depreciation decreased fixed assets by approximately \$800 thousand and the Due from Debenture Advances from Farm & Home account decreased \$1.5 million. There were increases of \$457 thousand in Accounts Receivable and \$881 thousand in Prepaid accounts.

Total liabilities decreased \$595 million from \$2.5 billion at December 31, 2003 to \$1.9 billion in December of 2004. This decrease is the result of the retiring \$594 million of bonds through maturities or early redemptions; the costs of issuance/premiums were expensed at the time of redemption and accrued interest & other liabilities decreased due to debt service and a reduction in interest payable for the bonds.

Fund equity decreased by \$19.9 million from \$259.6 million December 31, 2003 to \$239.7 million December 31, 2004 as a result of the excess of expenses over revenues of \$20 million. The loss December, 2004 was \$754 thousand compared to a loss of \$3.6 million December, 2003.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**BALANCE SHEETS  
DECEMBER 31, 2004 AND 2003**

	<b>2004</b>	<b>2003</b>	<b>Change</b>
<b>ASSETS</b>			
Current assets:			
Cash and cash equivalents:			
Cash In State Treasury	\$11,944,674	\$7,475,220	\$4,469,454
State of California's Surplus Money Investment Fund	369,234,000	826,317,000	(457,083,000)
Total cash and cash equivalents	381,178,674	833,792,220	(452,613,546)
Receivables under contracts of sale, net of allowance for uncollectible contracts of \$8,540 in 2004 and \$10,040 in 2003	1,527,857,538	1,561,043,509	(33,185,971)
Interest Receivable:			
Contracts of sale	7,954,978	8,405,902	(450,924)
State of California's Surplus Money Investment Fund	2,033,295	2,966,768	(933,473)
Other investments	802,156	1,606,585	(804,429)
Total current assets	1,919,826,641	2,407,814,983	(487,988,342)
Noncurrent assets:			
Investments:			
Guaranteed investment contracts	157,135,840	285,593,369	(128,457,529)
Insurance administrators	6,050,000	1,850,000	4,200,000
Total investments	163,185,840	287,443,369	(124,257,529)
Due from Veterans Debenture Revenue Fund	37,567,500	39,067,500	(1,500,000)
Other real estate owned, net of allowance for losses of \$527 in 2004 and \$1,020 in 2003	2,299,061	4,369,495	(2,070,434)
Land, improvements and equipment, net of accumulated depreciation of \$13,163 in 2004 and \$12,362 in 2003	2,947,773	3,741,739	(793,966)
Other	1,653,228	300,005	1,353,223
Total noncurrent assets	207,653,403	334,922,109	(127,268,706)
Total assets	<u>\$2,127,480,044</u>	<u>\$2,742,737,092</u>	<u>(\$615,257,048)</u>

**LIABILITIES AND FUND EQUITY**

## Current liabilities:

Bonds payable - current portion	\$34,370,000	\$30,560,000	\$3,810,000
Accrued interest and other liabilities	30,416,845	34,426,129	(4,009,284)
Due to other funds	<u>1,327,868</u>	<u>972,958</u>	<u>354,910</u>
Total current liabilities	66,114,713	65,959,086	155,626

## Noncurrent liabilities:

Bonds payable - noncurrent portion	1,802,094,196	2,394,958,743	(592,864,547)
Insurance claims payable and loss reserves	<u>19,490,600</u>	<u>22,123,807</u>	<u>(2,633,207)</u>
Total noncurrent liabilities	<u>1,821,584,796</u>	<u>2,417,082,549</u>	<u>(595,497,753)</u>
Total liabilities	<u>1,887,699,509</u>	<u>2,483,041,636</u>	<u>(595,342,127)</u>

## Fund equity:

Retained Earnings	249,367,170	277,931,118	(28,563,948)
Gain/(Loss)	<u>(9,586,635)</u>	<u>(18,235,662)</u>	<u>8,649,027</u>
Total fund equity	<u>239,780,535</u>	<u>259,695,456</u>	<u>(19,914,921)</u>
Total liabilities and fund equity	<u>\$2,127,480,044</u>	<u>\$2,742,737,092</u>	<u>(\$615,257,048)</u>

**Condensed Financial Information:**

(In thousands of dollars)

**Revenues, Expenses and Changes in Fund Equity**

**Condensed Statements of Revenues, Expenses and Changes in Fund Equity**

	July - Dec 2004	July - Dec 2003	% Change
<b>PROGRAM OPERATIONS:</b>			
Interest revenues:			
Contracts of Sale	\$ 46,509	\$ 52,551	-11.50%
Investments and other	9,787	15,848	-38.24%
	56,296	68,399	-17.69%
Expenses:			
Interest expense	57,245	76,504	-25.17%
Other Expenses	-	-	-
Total program operating expenses	57,245	76,504	-25.17%
Excess of program operations revenue over program operations expense	(949)	(8,105)	-88.29%
<b>PROGRAM ADMINISTRATION:</b>			
Total program administration revenues	4,119	4,086	0.81%
Total program administration expenses	13,011	15,104	-13.86%
Excess of program administration revenue over program administration expense.	(8,892)	(11,018)	-19.29%
Gain on sale of repossessed property	254	887	-71.36%
Total	\$ (9,587)	\$ (18,236)	-47.43%

**Program Operations**

Principally due to the decline of the Program's loan portfolio, the program interest revenues from the Contracts of Sale decreased by \$6.0 million from \$52.5 million for the period ended December 31, 2003 to \$46.5 million for the period ended December 31, 2004.

The interest revenues on investments decreased by \$6.0 million from \$15.8 million for the period ended December 31, 2003 to \$9.8 million for the period ended December 31, 2004. This decrease is due to increased Contracts of Purchase prepayments resulting in a shift of assets from higher yielding contracts of sale to low yielding short term investment accounts. Interest expense decreased \$19.2 million for the period due to maturities and the early redemption of bonds.

**Program Administration**

The revenues for program administration are limited primarily to fees collected from the program participants and the net of amounts charged for the fire and hazard insurance program. The total program administration revenues increased by \$33 thousand or from \$4.09 million for the period ended December 31, 2003 to \$4.12 million for the period ended December 31, 2004.

Program administration expenses consist of payroll and related costs, general and administrative cost and have decreased \$2 million for the period.

The loss for the month of December, 2004 was \$754 thousand compared to \$3.6 million December, 2003. Losses for the month of December were reduced by a transfer in from Debenture Fund of approximately \$1 million of interest income received from investments on Debenture's books.

VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN RETAINED EARNINGS  
YEAR TO DATE JULY - DECEMBER 2004 AND 2003

	July - Dec 2004	July - Dec 2003	Change
PROGRAM OPERATIONS:			
Interest revenues:			
Contracts of sale of properties	\$46,509,420	\$52,550,650	(\$6,041,230)
Investments and other	8,767,871	14,845,967	(6,078,097)
Transfers of revenue from Veterans Debenture Revenue Fund	1,018,863	1,002,418	16,445
	<u>56,296,153</u>	<u>68,399,035</u>	<u>(12,102,882)</u>
Total program operations revenues			
Expenses:			
Interest expense	57,245,097	76,503,906	(19,258,809)
Reversal of allowance for uncollectible contracts			-
	<u>57,245,097</u>	<u>76,503,906</u>	<u>(19,258,809)</u>
Total program operations expenses			
Excess of program operations revenues over program operations expenses	<u>(948,944)</u>	<u>(8,104,871)</u>	<u>7,155,927</u>
PROGRAM ADMINISTRATION:			
Revenues:			
Loan fees	2,599,134	3,632,948	(1,033,814)
Other income	516,733	602,402	(85,669)
Excess of amounts charged to contract holders over fire and hazard insurance claims and expenses and changes in insurance reserves	1,002,921	(148,957)	1,151,878
	<u>4,118,788</u>	<u>4,086,393</u>	<u>32,394</u>
Total program administration revenues			
Expenses:			
Payroll and related costs	6,417,148	6,882,179	(465,031)
General and administrative expenses	4,842,540	6,091,930	(1,249,390)
Excess of self-insured life and disability insurance claims and expenses and changes in insurance reserves over amounts charged to contract holders	1,750,953	2,130,210	(379,257)
	<u>13,010,641</u>	<u>15,104,320</u>	<u>(2,093,678)</u>
Total program administration expenses			
Excess of program administration expenses over program administration revenues	<u>(8,891,853)</u>	<u>(11,017,926)</u>	<u>2,126,073</u>
GAIN (LOSS) ON SALE OF REPOSSESSED PROPERTY	<u>254,162</u>	<u>887,136</u>	<u>(632,974)</u>
EXCESS OF REVENUES OVER EXPENSES	<u>(9,586,635)</u>	<u>(18,235,662)</u>	<u>8,649,026</u>
RETAINED EARNINGS:			
Beginning of year	<u>249,367,170</u>	<u>277,931,118</u>	<u>(28,563,948)</u>
End of year	<u>\$239,780,535</u>	<u>\$259,695,456</u>	<u>(\$19,914,922)</u>

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**APPENDIX B**

**FINANCIAL STATEMENTS OF THE VETERANS DEBENTURE REVENUE FUND  
FOR FISCAL YEARS 2004 AND 2003  
AND INDEPENDENT AUDITOR'S REPORT**



***Veterans Debenture  
Revenue Fund, Department  
of Veterans Affairs, State of  
California***

*Financial Statements for the Years Ended  
June 30, 2004 and 2003 and Independent  
Auditors' Report*

## INDEPENDENT AUDITORS' REPORT

California Veterans Board  
State of California  
Sacramento, California

We have audited the accompanying balance sheets of the Veterans Debenture Revenue Fund, Department of Veterans Affairs of the State of California (the "Department") as of June 30, 2004 and 2003, and the related statements of revenues, expenses and changes in fund equity, and of cash flows for the years then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Veterans Debenture Revenue Fund and are not intended to present the financial position of the Department of Veterans Affairs of the State of California or the results of its operations and cash flows of its proprietary funds.

In our opinion, such financial statements referred to above present fairly, in all material respects, the financial position of the Veterans Debenture Revenue Fund, Department of Veterans Affairs of the State of California as of June 30, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Management's Discussion and Analysis is not a required part of the financial statements, but is supplementary information required by the GASB. The supplementary information is the responsibility of the Department's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and we do not express an opinion on it.

*Deloitte + Touche LLP*

October 12, 2004

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND RESULTS OF OPERATIONS**

The Veterans Debenture Revenue Fund, Department of Veterans Affairs, State of California (the "Fund") was established for the maintenance of a Bond Reserve Account as required by the revenue bond resolution of the Department of Veterans Affairs of the State of California (the "Department"). The resolution requires a reserve in an amount equal to three percent of the aggregate outstanding principal of all Revenue Bonds with interest rates fixed to maturity held by the Department.

The enclosed financial statements present the Fund's balance sheets, statements of revenues, expenses and changes in fund equity and cash flows.

During fiscal year 2004, the Department retired \$28,655,000 of outstanding Revenue bonds of the Veterans Farm and Home Building Fund of 1943. The Department issued Home Purchase Revenue bonds totaling \$124,635,000 with variable interest rates. The interest rate for the new issue is 1.11% as of June 30, 2004. Bond proceeds from the Home Purchase Revenue bond issues were used to refund previously issued General Obligation bonds of \$124,635,000. The Department did not issue any General Obligation bonds during fiscal year 2004. The Department increased the reserve balance in the Fund \$500,000 in fiscal year 2004. The Department increased the reserve by \$500,000 in the Fund in fiscal year 2004 due to the retirement of the Revenue Bond debt and the issuance of the Series 2003A bonds.

All income generated by the Fund represents amounts due to the Farm and Home Fund and accordingly have been reflected as operating transfers out in the statements of revenues, expenses and changes in fund equity.

**VETERANS DEBENTURE REVENUE FUND  
DEPARTMENT OF VETERANS AFFAIRS,  
STATE OF CALIFORNIA**

**BALANCE SHEETS  
JUNE 30, 2004 AND 2003**

	<b>2004</b>	<b>2003</b>
<b>ASSETS</b>		
CURRENT ASSETS:		
Cash in State Treasury	\$ 800	\$ 800
Investments in State of California's Surplus Money Investment Fund (at fair value)	3,288,000	2,788,000
Investment agreements (at cost)	27,276,500	27,276,500
Investments in U.S. treasury notes and bonds (at fair value)	6,763,360	7,143,979
Interest receivable:		
State of California's Surplus Money Investment Fund	12,451	12,592
U.S. Treasury notes and bonds	50,566	52,918
Investment contracts	<u>139,912</u>	<u>136,328</u>
<b>TOTAL</b>	<b><u>\$37,531,589</u></b>	<b><u>\$37,411,117</u></b>
<b>LIABILITIES AND FUND EQUITY</b>		
CURRENT LIABILITIES—Income from investments due to the Veterans Farm and Home Building Fund of 1943	\$ (35,911)	\$ 343,617
NONCURRENT LIABILITIES—Bond reserve due to the Veterans Farm and Home Building Fund of 1943	<u>37,567,500</u>	<u>37,067,500</u>
Total liabilities	37,531,589	37,411,117
FUND EQUITY	<u>-</u>	<u>-</u>
<b>TOTAL</b>	<b><u>\$37,531,589</u></b>	<b><u>\$37,411,117</u></b>

See notes to financial statements.

**VETERANS DEBENTURE REVENUE FUND  
DEPARTMENT OF VETERANS AFFAIRS,  
STATE OF CALIFORNIA**

**STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN FUND EQUITY  
YEARS ENDED JUNE 30, 2004 AND 2003**

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	<b>2004</b>	<b>2003</b>
REVENUES—Income from investments	\$2,009,414	\$2,029,379
EXPENSES—Transfers out to Veterans Farm and Home Building Fund of 1943	<u>2,009,414</u>	<u>2,029,379</u>
EXCESS OF REVENUES OVER EXPENSES		
FUND EQUITY—Beginning of year	<u>-</u>	<u>-</u>
FUND EQUITY—End of year	<u>\$ -</u>	<u>\$ -</u>

See notes to financial statements.

**VETERANS DEBENTURE REVENUE FUND  
DEPARTMENT OF VETERANS AFFAIRS,  
STATE OF CALIFORNIA**

**STATEMENTS OF CASH FLOWS  
YEARS ENDED JUNE 30, 2004 AND 2003**

	<b>2004</b>	<b>2003</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Receipts from investment income	\$ 2,008,323	\$ 2,037,319
Payments to other funds	<u>(1,888,942)</u>	<u>(1,964,016)</u>
Net cash provided by operating activities	<u>119,381</u>	<u>73,303</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Decrease in investment securities	<u>(119,381)</u>	<u>(73,303)</u>
Net cash used in investing activities	<u>(119,381)</u>	<u>(73,303)</u>
<b>NET (DECREASE) INCREASE IN CASH IN STATE TREASURY</b>	<u>-</u>	<u>-</u>
<b>CASH IN STATE TREASURY:</b>		
Beginning of year	<u>800</u>	<u>800</u>
End of year	<u>\$ 800</u>	<u>\$ 800</u>
<b>RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:</b>		
Excess of revenues over expenses	\$ -	\$ -
Adjustments to reconcile to net cash used by operating activities—effect of changes in assets and liabilities:		
Interest receivable	(1,091)	7,940
Income from investments due to the Veterans Farm and Home Building Fund of 1943	(379,528)	65,363
Bond reserve due to the Veterans Farm and Home Building Fund of 1943	<u>500,000</u>	<u>-</u>
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<u>\$ 119,381</u>	<u>\$ 73,303</u>

See notes to financial statements.

**VETERANS DEBENTURE REVENUE FUND  
DEPARTMENT OF VETERANS AFFAIRS,  
STATE OF CALIFORNIA**

**NOTES TO FINANCIAL STATEMENTS  
YEARS ENDED JUNE 30, 2004 AND 2003**

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**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Description of the Fund**—The California Department of Veterans Affairs (the “Department”) is a separate legal entity, acting as a Cabinet level agency of the State of California. A seven-member California Veterans Board (the Board) has policy oversight of the operations of the Department. The Board’s membership consists of the seven members, all of whom are appointed by the Governor, subject to confirmation by the State Senate. The Department is authorized to issue revenue bonds to fund low-interest farm and home loan contracts with veterans living in California.

In December 1997, the Department amended the revenue bond resolution provision regarding the Bond Reserve Account in the Veterans Debenture Revenue Fund (the Fund). The revenue bond resolution requires the establishment and maintenance of a Bond Reserve Account in an amount equal to three percent of the aggregate outstanding principal amount of all Revenue Bonds with interest rates fixed to maturity. To calculate the reserve requirement, the Ninth Supplemental Resolution established, with respect to the revenue bonds with interest rates fixed to maturity issued pursuant to such resolution (1997 Series A, B and C Bonds, 1998 Series A Bonds, 1999 Series A and B Bonds, 2000 Series A, B and C Bonds, 2001 Series A Bonds), a requirement equal to at least seven percent of the outstanding principal amount of such Revenue Bonds. With respect to the 2002 Series A Bonds, the Resolution requires an amount equal to at least five percent of the outstanding principal amount of such Revenue Bonds. Amounts in the Bond Reserve Account shall be used solely for the purposes of paying the principal of and the interest on the Revenue Bonds and for making Mandatory Sinking Account Payments on Revenue Bonds. Amounts on deposit in the Bond Reserve Account in excess of the bond reserve requirement, may be transferred out of the Veterans Debenture Revenue Fund to the Veterans Farm and Home Building Fund of 1943 (Farm and Home Fund), at the request of the Department. Investment earnings of the Veterans Debenture Revenue Fund are transferred to the Farm and Home Fund.

At June 30, 2004 and 2003, the liabilities of the Veterans Debenture Revenue Fund represent amounts due to the Farm and Home Fund and, accordingly, are included as a receivable in the financial statements of the Farm and Home Fund.

The financial statements represent only the activities of the Veterans Debenture Revenue Fund and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary funds. The financial statements of the Fund are included in the financial statements of the State of California as the State represents the primary government and has ultimate oversight responsibility for the Fund.

**Use of Estimates in the Preparation of Financial Statements**—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Basis of Accounting**—The fund has been classified as a proprietary fund type for accounting purposes. Generally, revenues are recorded when earned and become measurable, and expenses are recognized as incurred.

**Cash and Investments**—All investments are reported at fair value except for nonparticipating fixed interest investment agreements which are valued using cost based measures. The fair value of investments is based on published market prices and quotations from major investment brokers and from the State of California for the

Surplus Money Investment Fund. Income from investments includes net unrealized appreciation or depreciation in the fair value of investments.

***Revenues and Operating Transfers***—Income from investments are recorded as earned. A corresponding operating transfer out is recorded to reflect the required transfer to the Farm and Home Fund.

## **2. CASH AND INVESTMENTS**

Cash in State Treasury of \$800 as of June 30, 2004 and 2003 represents amounts held in the Fund's general operating account with the State Treasury. These monies are pooled with the monies of other state agencies and invested by the State Treasurer's office. These investments are not individually identifiable.

Investment of bond funds is restricted by applicable California law and the various bond resolutions associated with each issuance, generally, to certain types of investments, including direct obligations of the U.S. Government and its agencies, the State of California's Surplus Money Investment Fund, and investment agreements with financial institutions rated within the top two ratings of a nationally recognized rating service.

The Fund's investment in four investment agreements of \$27,276,500 as of June 30, 2004 is carried at cost. All investment agreements are fixed rate contracts. The contracts mature from 2015 to 2028 and bear interest from 5.38% to 6.90%.

All of the Fund's investments in U.S. Treasury notes and bonds are categorized as risk category 1, which is defined by the GASB Statement No. 3 as investments that are insured or registered or for which the securities are held by the Fund or its agent in the Fund's name. In accordance with GASB Statement No. 3, the Fund's investments held in the State of California's Surplus Money Investment Fund and the investment agreements are not categorized as to risk.

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## APPENDIX C

### CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA

#### Contracts of Purchase

Set forth below is certain financial information regarding Contracts of Purchase.

#### *Existing Contracts of Purchase*

The following charts describe the current loan to value ratios and geographic distribution of Contracts of Purchase financed under the Program as of December 31, 2004 using proceeds of Veterans G.O. Bonds, Revenue Bonds and other amounts under the 1943 Fund.

#### Current Loan-to-Value Ratio of Contracts of Purchase<sup>(1)(2)</sup>

	<u>Uninsured</u>	<u>Radian Insured<sup>(5)</sup></u>	<u>Radian Insured<sup>(6)</sup></u>	<u>VA Guaranteed</u>	<u>Total</u>
<b>Single Family Homes</b>					
Less than 30% LTV	\$ 88,571	\$ 555	\$ 168	\$ 177	\$ 89,472
30-49% LTV .....	150,371	2,729	389	835	154,325
50-59% LTV .....	105,730	4,428	476	396	111,030
60-69% LTV .....	115,318	12,974	930	1,488	130,709
70-79% LTV .....	185,968	75,987	5,572	5,110	272,637
Sub-total .....	\$ 645,958	\$ 96,673	\$ 7,535	\$ 8,007	\$ 758,172
80-84% LTV .....	\$ 11,854	\$ 64,995	\$ 27,202	\$ 10,388	\$ 114,439
85-89% LTV .....	8,050	34,531	75,022	27,444	145,047
90-94% LTV .....	8,710	30,891	211,187	69,225	320,014
95-97% LTV .....	6,080	165	84,227	18,640	109,113
Sub-total .....	\$ 34,694	\$ 130,582	\$ 397,638	\$ 125,698	\$ 688,613
<b>Greater than 97% LTV</b>	\$ 2,136	\$ 288	\$ 3,158	\$ 36,286	\$ 41,868
<b>Other Property Types</b>					
Farms .....	\$ 3,977	\$ 186	\$ 577	\$ -	\$ 4,741
Mobile Homes in Parks .....	5,650	-	3,659	-	9,310
Homes under Construction .....	18,446	57	3,668	-	22,171
Sub-total .....	\$ 28,073	\$ 244	\$ 7,905	\$ -	\$ 36,222
<b>Special Status</b>					
<b>Contracts of Purchase</b>					
Real Estate Owned <sup>(3)</sup> .....	\$ 1,050	\$ 242	\$ 728	\$ -	\$ 2,020
Disability Program <sup>(4)</sup> .....	11,328	866	-	-	12,193
Sub-total .....	\$ 12,377	\$ 1,108	\$ 728	\$ -	\$ 14,213
Total Portfolio .....	\$ 723,239	\$ 228,896	\$ 416,964	\$ 169,990	\$ 1,539,089

(1) 000's omitted

(2) LTV based on current Contracts of Purchase balance divided by original appraised value of the property, except that the Department updates the appraised value of the home when the veteran applies for a home improvement loan. In such cases, the LTV is calculated with the new appraised value.

(3) Repossessed properties and delinquent Contracts of Purchase carried as REO on financial statements.

(4) Contracts of Purchase where payments are made on behalf of veterans by the Department's life and disability coverage plan.

(5) The policy was executed on February 28, 1998.

(6) The policy was executed on July 1, 2000.

### Geographic Distribution of Contracts of Purchase

<u>County</u>	<u>Approximate Current Contract Balance</u>
Sacramento .....	\$ 144,786,412
Riverside.....	142,161,618
San Diego .....	123,522,105
San Bernardino .....	116,156,747
Los Angeles .....	108,866,369
Fresno .....	88,125,939
Kern .....	88,068,919
Shasta .....	51,957,313
San Joaquin .....	44,421,746
Placer .....	43,585,645
Solano .....	42,989,211
Orange .....	36,474,409
Contra Costa .....	26,095,549
Other Northern California Counties .....	260,379,926
Other Central California Counties .....	181,521,040
Other Southern California Counties .....	39,975,721
Statewide—California .....	<u>\$ 1,539,088,669</u>

### Contracts of Purchase Origination and Principal Repayment Experience

The following tables represent, respectively, a historical picture of Contract of Purchase originations since the 1985 fiscal year and selected principal repayments with respect to Contracts of Purchase since the 1985 fiscal year.

#### New Contracts of Purchase During the Fiscal Year<sup>(1)</sup>

<u>Fiscal Year Ending June 30</u>	<u>Veterans G.O. Bonds</u>		<u>Unrestricted Funds</u>		<u>Revenue Bonds</u>		<u>Total</u>	
	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
1985 .....	4,196	\$ 290,885,900			2,301	\$ 154,244,600	6,497	\$ 445,130,500
1986 .....	3,484	243,955,800			2,401	160,782,200	5,885	404,738,000
1987 .....	1,569	108,789,700			1,160	75,836,800	2,729	184,626,500
1988 .....	2,958	236,054,500			1,397	99,040,900	4,355	335,095,400
1989 .....	3,112	252,796,300			1,154	83,076,100	4,266	335,872,400
1990 .....	2,097	187,445,600			522	38,150,800	2,619	225,596,400
1991 .....	1,927	200,393,500			359	29,189,600	2,286	229,583,100
1992 .....	1,086	111,600,500			388	34,671,600	1,474	146,272,100
1993 .....	740	94,417,100			286	27,443,800	1,026	121,860,900
1994 .....	843	117,213,779			337	34,740,536	1,180	151,954,315
1995 .....	2,109	286,178,376			822	84,860,894	2,931	371,039,270
1996 .....	762	107,751,444			222	22,723,617	984	130,475,061
1997 .....	766	118,344,636			201	21,853,933	967	140,198,569
1998 .....	615	99,224,002	188	\$17,716,376	164	18,871,066	967	135,811,444
1999 .....	758	129,521,359	575	92,728,280	274	33,284,343	1,607	255,533,982
2000 .....	1,045	185,180,534	1,725	333,328,690	708	92,214,409	3,478	610,723,633
2001 .....	844	135,498,480	1,211	232,445,146	697	101,175,512	2,752	469,119,138
2002 .....	334	57,109,103	416	74,798,670	204	27,178,525	954	158,981,879
2003 .....	357	68,105,508	508	99,179,927	123	16,285,625	988	183,496,397
2004 .....	444	97,223,818	1,173	274,187,085	165	26,109,792	1,782	397,520,696
2005 <sup>(2)</sup> .....	191	42,087,836	458	107,871,805	161	29,826,135	810	179,785,776

(1) Number of new Contracts of Purchase does not include home improvement loans.

(2) 6-month period through December 31, 2004.

**Selected Principal Flows with respect to Contracts of Purchase  
Funded by both Veterans G.O. Bonds and Revenue Bonds**

<b>Fiscal Year Ending June 30</b>	<b>Contracts Funded During Year (000s)</b>	<b>Contract Prepayments During Year (000s)</b>	<b>Other Principal Receipts-Losses During Year (000s)</b>	<b>Contract Balance at End of Year (000s)</b>	<b>Average Rate on all Outstanding Contracts</b>	<b>Average of Monthly FHLMC 30-year Conventional Loan Rate</b>	<b>Annual Average Prepayment Rate</b>	<b>Annual Average Origination Rate</b>
<b>Principal Flows</b>					<b>Rates</b>			
1985.....	\$ 445,131	\$ 123,669	\$ 88,308	\$ 3,142,526	8.0%	13.8%	4.1%	14.7%
1986.....	404,738	179,809	94,970	3,272,485	8.0	11.5	5.6	12.6
1987.....	184,627	261,675	99,569	3,095,868	7.7	9.8	8.2	5.8
1988.....	335,095	198,396	114,178	3,118,389	7.0	10.5	6.4	10.8
1989.....	335,872	207,471	105,896	3,140,894	7.3	10.6	6.6	10.7
1990.....	225,596	232,085	96,639	3,037,766	8.0	10.1	7.5	7.3
1991.....	229,583	191,895	92,722	2,982,732	8.0	9.9	6.4	7.6
1992.....	146,272	246,150	92,975	2,789,879	8.0	9.0	8.5	5.1
1993.....	121,861	273,817	105,629	2,532,294	8.0	8.0	10.3	4.6
1994.....	151,954	359,749	98,773	2,225,726	8.0	7.3	15.1	6.4
1995.....	371,039	111,984	74,706	2,410,075	7.8	8.7	4.8	16.0
1996.....	130,475	141,767	92,521	2,306,262	8.0	7.5	6.0	5.5
1997.....	140,199	111,254	106,027	2,229,180	8.0	7.9	4.9	6.2
1998.....	135,811	172,134	94,106	2,098,752	7.7	7.2	8.0	6.3
1999.....	255,534	183,776	101,254	2,069,256	6.9	6.9	8.8	12.3
2000.....	610,724	138,401	106,522	2,435,056	6.8	8.1	6.1	27.1
2001.....	469,119	189,902	91,033	2,623,241	6.8	7.5	7.5	18.5
2002.....	158,982	330,068	86,556	2,365,599	6.8	6.9	13.2	6.4
2003.....	183,496	701,785	74,643	1,772,667	6.7	5.9	33.9	8.9
2004.....	397,521	576,907	53,833	1,539,448	6.4	5.9	34.8	24.0
2005 <sup>(2)</sup> .....	<u>179,786</u>	<u>150,854</u>	<u>29,291</u>	1,539,089	6.0	5.8	19.6	23.4
	\$ 5,613,416	\$ 5,083,548	\$ 1,900,151					

**Reservation rates on new Contracts of Purchase for period:**

<b>Period</b>	<b>Veterans G.O. Bonds<sup>(1)</sup></b>	<b>Unrestricted Funds</b>	<b>Revenue Bonds</b>
Prior to January 1, 1999, substantially all newly originated Contracts have the same rate as the then outstanding Contracts.			
January 1, 1999 thru June 30, 2000	6.65%	6.65%	5.95%
July 1, 2000 thru February 28, 2001	7.50%	7.95%	6.95%
March 1, 2001 thru May 31, 2001	6.50%	7.95%	6.40%
June 1, 2001 thru August 31, 2001	6.50%	7.10%	6.40%
September 1, 2001 thru April 1, 2002	6.25%	6.50%	6.00%
April 2, 2002 thru July 31, 2002	5.90%	5.50%	5.80%
August 1, 2002 thru December 1, 2002	5.50%	6.00%	5.80%
December 2, 2002 thru June 15, 2003	4.99%	5.40%	5.25%
June 16, 2003 thru September 1, 2003	4.25%	4.50%	4.50%
September 1, 2003 thru September 15, 2003	4.25%	4.99%	4.50%
September 16, 2003 thru May 5, 2004	4.50%	4.99%	4.50%
May 6, 2004 thru June 1, 2004	4.75%	5.25%	4.75%
June 2, 2004 thru December 13, 2004	4.95%	5.50%	5.10%
December 14, 2004 thru April 3, 2005	4.95%	5.50%	5.50%
April 4, 2005 forward	5.15%	5.50%	5.50%

(1) Rates for contracts of purchase for mobile home in parks shall be 1% higher than the applicable established rates.

(2) 6-month period through December 31, 2004.

## Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments

The following table shows amounts expected to be available to fund Contracts of Purchase from Veterans G.O. Bonds and Revenue Bonds. Additional moneys may become available to finance Contracts of Purchase through the future issuances of Veterans G.O. Bonds and Revenue Bonds. The Department has full discretion to use moneys available from prior, current or future bond issues in any order of priority it chooses. As of December 31, 2004, the Department had 353 pending applications for Contracts of Purchase in the aggregate amount of approximately \$74,509,000.

Bond Series	Deposit as of	Balance as of	Respective Series Bond Proceeds Subaccounts			Investment	Investment Rate (%)
			Unrestricted Moneys <sup>(1)</sup>	Qualified Veterans Mortgage Bond Proceeds <sup>(1)</sup>	Qualified Mortgage Bond Proceeds <sup>(1)</sup>		
Veterans G.O. Bond Recycling Subaccounts							
Unrestricted.....	4/28/05	12/31/04	\$ 81,238	-0-	-0-	SMIF <sup>(2)</sup>	Variable
Unrestricted.....			\$ 120,000 <sup>(8)</sup>	-0-	-0-	SMIF <sup>(2)</sup>	Variable
QVMB Reimbursement .....		12/31/04	\$ 8,580 <sup>(6)</sup>	-0-	-0-	SMIF <sup>(2)</sup>	Variable
QMB Reimbursement .....		12/31/04	\$ 12,920 <sup>(7)</sup>	-0-	-0-	SMIF <sup>(2)</sup>	Variable
Other G.O. Series.....		12/31/04	\$ 725	\$ 1,780		SMIF <sup>(2)</sup>	Variable
Total Veterans G.O. Bonds .....			\$ 223,463	\$ 1,780	-0-		
Revenue Bonds Recycling Subaccounts							
1991 A Recycling.....		12/31/04	\$ 12,710	-0-	-0-	BLB <sup>(3)</sup>	6.060
1999 A/B.....		12/31/04	\$ 670	-0-	-0-	BLB <sup>(4)</sup>	5.300
2000 A/B/C .....		12/31/04	\$ 951	-0-	-0-	WestLB <sup>(5)</sup>	6.460
2001 A .....		12/31/04	\$ 6,800	-0-	-0-	BLB <sup>(9)</sup>	5.670
2003 A .....		12/31/04	\$ 1,000	-0-	-0-	SMIF <sup>(2)</sup>	Variable
Total Revenue Bonds .....			\$ 22,131	-0-	-0-		
Grand Total .....			\$ 245,594	\$ 1,780	\$ -0-		

(1) 000's omitted.

(2) Surplus Money Investment Fund. Amounts invested in SMIF may be withdrawn and reinvested at any time.

(3) Investment agreement maturing December 1, 2009 with Bayerische Landesbank Girozentrale.

(4) Investment agreement maturing December 1, 2028 with Bayerische Landesbank Girozentrale.

(5) Investment agreement maturing June 1, 2010 with Westdeutsche Landesbank Girozentrale. S&P has announced a negative ratings outlook for this bank.

(6) These funds are currently being utilized to fund contracts in anticipation of reimbursement by proceeds of future issuance of Qualified Veterans Mortgage Bonds.

(7) These funds are currently being utilized to fund contracts in anticipation of reimbursement by proceeds of future issuance of Qualified Mortgage Bonds.

(8) Reimbursement proceeds of the Offered Veterans G.O. Bonds.

(9) Investment agreement maturing December 1, 2011 with Bayerische Landesbank Girozentrale.

## Cancellations and Delinquencies

Set forth in the table below is a comparative chart of delinquent, cancelled and repossessed Contracts of Purchase and certain comparative information regarding USDVA guaranteed loans during the same period.

	1997 <sup>(1)</sup>	1998 <sup>(1)</sup>	1999 <sup>(1)</sup>	2000 <sup>(2)</sup>	2001 <sup>(2)</sup>	2002 <sup>(2)</sup>	2003 <sup>(2)</sup>	2004 <sup>(2)</sup>	2005 <sup>(3)</sup>
<b>Percentage of Number of Contracts of Purchase</b>									
<b>Delinquent</b>									
30-60 days <sup>(6)</sup> .....	-- <sup>(8)</sup>	-- <sup>(8)</sup>	-- <sup>(8)</sup>	3.91% <sup>(7)</sup>	4.24% <sup>(7)</sup>	3.52% <sup>(7)</sup>	3.13% <sup>(7)</sup>	2.97% <sup>(7)</sup>	3.18% <sup>(7)</sup>
60+ days <sup>(6)</sup> .....	-- <sup>(8)</sup>	-- <sup>(8)</sup>	-- <sup>(8)</sup>	2.88% <sup>(7)</sup>	3.16% <sup>(7)</sup>	2.43% <sup>(7)</sup>	2.03% <sup>(7)</sup>	1.43% <sup>(7)</sup>	1.48% <sup>(7)</sup>
Cancelled Contracts and Real Estate in inventory <sup>(4)</sup> .....	-- <sup>(8)</sup>	-- <sup>(8)</sup>	-- <sup>(8)</sup>	0.72% <sup>(7)</sup>	0.69% <sup>(7)</sup>	0.41% <sup>(7)</sup>	0.32% <sup>(7)</sup>	0.22% <sup>(7)</sup>	0.12% <sup>(7)</sup>
<b>USDVA Guaranteed Loans<sup>(5)</sup></b>									
<b>Percentages in U.S.</b>									
<b>Delinquent</b>									
30-60 days .....	4.54%	4.45%	4.35%	4.19%	4.71%	4.87%	4.83%	4.53%	4.49%
60+ days .....	2.21%	2.35%	2.26%	2.25%	2.65%	2.85%	3.15%	2.90%	3.10%
Foreclosures in inventory .....	1.81%	1.77%	1.82%	1.44%	1.20%	1.72%	1.49%	1.45%	1.50%
<b>Percentages in California</b>									
<b>Delinquent</b>									
30-60 days .....	4.30%	4.28%	4.13%	4.05%	4.57%	4.57%	4.67%	4.09%	3.52%
60+ days .....	2.52%	2.61%	2.45%	2.27%	2.49%	2.57%	2.79%	2.34%	2.11%
Foreclosures in inventory .....	3.54%	2.92%	2.28%	1.39%	0.93%	1.12%	0.93%	0.69%	0.60%

(1) As of June 18 for Department's and as of June 30 for USDVA data.

(2) As of June 30 for Department's and USDVA data.

(3) As of December 31, 2004 for Department's and as of December 31, 2004 for USDVA data.

(4) Bankruptcies are included in cancelled Contracts statistics and do not exceed in any period more than 10% of total cancellations and bankruptcy category. Federal bankruptcy law precludes repossession action of Contracts of Purchase when veteran is in bankruptcy proceedings until the automatic stay is lifted.

(5) Source: National Delinquency Survey published by the Mortgage Bankers Association of America.

(6) As of the June 30, 1999 installation of the Integrated Loan Processing and Financial Information System, the Department reports delinquencies on a basis consistent with industry standards.

(7) The Department has adjusted the criteria used to identify delinquent contracts from \$25 or more delinquent to over \$3 delinquent. The data below represents the breakout of delinquent, repayment/forbearance agreements and cancelled contracts and real estate in inventory. These figures include contracts that were the subject of forbearance or repayment agreements between the Department and the contract holder.

	2000 <sup>(2)</sup>	2001 <sup>(2)</sup>	2002 <sup>(2)</sup>	2003 <sup>(2)</sup>	2004 <sup>(2)</sup>	2005 <sup>(3)</sup>
<b>Percentage of Number of Contracts of Purchase</b>						
<b>Delinquent, Repayment/Forbearance Agreements, and Cancelled Contracts and Real Estate in inventory</b>						
30-60 days (Delinquent) .....	3.78%	3.98%	2.95%	2.77%	2.72%	2.96%
30-60 days (Repayment/Forbearance Agreement) .....	0.13%	0.26%	0.57%	0.36%	0.25%	0.22%
<b>Total</b> .....	3.91%	4.24%	3.52%	3.13%	2.97%	3.18%
60+ days (Delinquent) .....	2.50%	2.29%	1.38%	1.32%	1.08%	1.17%
60+ days (Repayment/Forbearance Agreement) .....	0.38%	0.87%	1.05%	0.71%	0.35%	0.31%
<b>Total</b> .....	2.88%	3.16%	2.43%	2.03%	1.43%	1.48%
Cancelled Contracts and Real Estate in inventory .....	0.72%	0.63%	0.39%	0.31%	0.19%	0.12%
"Repayment/Forbearance Agreement" .....	-	0.06%	0.02%	0.01%	0.03%	0.00%
<b>Total</b> .....	0.72%	0.69%	0.41%	0.32%	0.22%	0.12%

(8) The data below represents the Department's reporting method prior to the implementation of the Integrated Loan Processing and Financial Information System. The Department's prior reporting system did not treat contracts that were the subject of forbearance or repayment agreements between the Department and the contract holder as delinquent. As a result, contracts that were the subject of forbearance or repayment agreements are not included in the 40-68+ days delinquent category, but were included in the cancelled contracts category.

	1996 <sup>(1)</sup>	1997 <sup>(1)</sup>	1998 <sup>(1)</sup>	1999 <sup>(1)</sup>
<b>Percentage of Number of Contracts of Purchase</b>				
<b>Delinquent<sup>(7)</sup></b>				
40-67 days .....	2.90%	1.65%	0.78%	0.87%
68+ days .....	2.50%	3.22%	1.99%	1.34%
Cancelled Contracts and Real Estate in inventory <sup>(4)</sup> .....	1.89%	1.86%	1.49%	0.94%

## Veterans G.O. Bonds and Revenue Bonds

The chart below sets forth certain information regarding Veterans G.O. Bonds and Revenue Bonds and assumes the issuance of the Offered Revenue Bonds and the 2005 G.O. Bonds (the "Spring 2005 Transactions.")

### Selected Information with Respect to Veterans G.O. Bonds and Revenue Bonds

<u>Series</u>	<u>Bonds Outstanding as of 12/31/04</u>	<u>Expected Bonds Outstanding as of 6/1/05</u>	<u>Final Maturity Date of Series</u>	<u>Next Optional Call Date</u>	<u>Call Price on Such Date</u>	<u>Maximum Coupon Subject to Optional Call</u>	<u>Bonds Subject to Special Redemption<sup>(6)</sup></u>
<b>Veterans G.O. Bonds Issued as Qualified Veterans Mortgage Bonds under the 1954 Code</b>							
AK.....	4,500,000	\$ 3,000,000	April 1, 2007	Non-callable	N.A.	N.A.	No
AL.....	12,000,000	8,000,000	April 1, 2007	Non-callable	N.A.	N.A.	No
AM.....	20,000,000	20,000,000	October 1, 2008	Non-callable	N.A.	N.A.	No
AN/AP.....	52,500,000	42,000,000	April 1, 2009	Non-callable	N.A.	N.A.	No
AQ.....	42,000,000	42,000,000	October 1, 2008	Non-callable	N.A.	N.A.	No
AR.....	22,000,000	22,000,000	October 1, 2009	Non-callable	N.A.	N.A.	No
AS.....	29,000,000	29,000,000	October 1, 2009	Non-callable	N.A.	N.A.	No
AT.....	117,985,000	100,715,000	February 1, 2010	Non-callable	N.A.	N.A.	No
AU.....	72,930,000	72,930,000	October 1, 2010	Non-callable	N.A.	N.A.	No
AV.....	49,780,000	49,780,000	October 1, 2010	Non-callable	N.A.	N.A.	No
Sub-total.....	\$ 422,695,000	\$ 389,425,000					
<b>Veterans G.O. Bonds Issued as Qualified Veterans Mortgage Bonds under the 1986 Code</b>							
BC/BF <sup>(1)</sup> .....	\$ 1,200,000	\$ 100,000	February 1, 2006	<sup>(3)</sup>	100%	5.65%	Allocated Prepayments <sup>(2)</sup>
BG/BH <sup>(8)</sup> .....	462,195,000	363,880,000	December 1, 2032	-- <sup>(4)</sup>	-- <sup>(4)</sup>	5.600% <sup>(4)</sup>	Excess Revenues
BJ7.....	2,895,000	2,895,000	December 1, 2012	December 1, 2009	101%	5.625%	Excess Revenues
BJ9.....	6,520,000	6,520,000	December 1, 2016	April 27, 2010	101%	5.600%	Excess Revenues
BK.....	100,000	100,000	December 1, 2005	-- <sup>(4)</sup>	-- <sup>(4)</sup>	N/A	Excess Revenues
BP.....	8,290,000	5,130,000	December 1, 2026	Anytime	100%	5.500%	Excess Revenues
BQ/BR.....	48,730,000	48,730,000	December 1, 2029	June 1, 2005	100%	5.300%	Excess Revenues
BS.....	1,000,000	1,000,000	December 1, 2008	Non-callable	N/A	N/A	Excess Revenues
BJ11/12 <sup>(5)</sup> .....	56,370,000	56,370,000	December 1, 2032	-- <sup>(5)</sup>	-- <sup>(5)</sup>	5.700%	Excess Revenues
BT/BU.....	76,630,000	76,630,000	December 1, 2026	December 1, 2005	101%	5.650%	Excess Revenues
BV/BW.....	30,735,000	30,735,000	December 1, 2032	June 1, 2006	101%	5.600%	Excess Revenues
BX.....	42,000,000	42,000,000	December 1, 2032	June 1, 2006	101%	5.500%	Excess Revenues
BY/BZ.....	111,325,000	111,325,000	December 1, 2024	June 1, 2007	101%	5.375%	Excess Revenues
CA/CB <sup>(7)</sup> .....	--	221,475,000	December 1, 2036	June 1, 2015	100%	5.050%	Excess Revenues
Sub-total.....	\$ 847,990,000	\$ 996,890,000					
TOTAL VETERANS G.O. BONDS.....	\$ 1,270,685,000	\$ 1,356,315,000					

<u>Series</u>	<u>Bonds Outstanding as of 12/31/04</u>	<u>Expected Bonds Outstanding as of 6/1/05</u>	<u>Final Maturity Date of Series</u>	<u>Next Optional Call Date</u>	<u>Call Price on Such Date</u>	<u>Maximum Coupon Subject to Optional Call</u>	<u>Bonds Subject to Special Redemption<sup>(6)</sup></u>
<b>Revenue Bonds Issued as Qualified Mortgage Bonds under the 1986 Code</b>							
1997 A/B.....	\$ 18,925,000	\$ 18,925,000	December 1, 2028	December 1, 2008	101%	5.500%	Excess Revenues
1997 C.....	54,855,000	54,855,000	December 1, 2019	January 9, 2011	101%	5.500%	Excess Revenues
1998 A.....	37,535,000	37,535,000	December 1, 2019	December 1, 2008	101%	5.450%	Excess Revenues
Sub-total.....	\$ 111,315,000	\$ 111,315,000					
<b>Revenue Bonds Issued to Refund Bonds Issued Prior to Mortgage Subsidy Bond Tax Act of 1980</b>							
1999 A .....	\$ 54,170,000	\$ 54,170,000	December 1, 2027	June 1, 2005	100%	5.200%	Excess Revenues
1999 B.....	86,085,000	86,086,000	December 1, 2028	June 1, 2005	100%	5.200%	Excess Revenues
2000 C <sup>(9)</sup> .....	42,600,000	-- <sup>(9)</sup>	December 1, 2027	June 1, 2005	101%	6.150%	Excess Revenues
2001 A .....	39,840,000	39,840,000	December 1, 2028	June 1, 2006	101%	5.600%	Excess Revenues /Unexpended
2002 A .....	117,200,000	117,200,000	December 1, 2027	June 1, 2012	101%	5.350%	Excess Revenues /Unexpended
2003 A .....	124,635,000	84,635,000 <sup>(9)</sup>	December 1, 2028	Anytime	100%	Variable	Excess Revenues
2005 A .....	--	42,600,000	December 1, 2027	June 1, 2015	100%	4.80%	Excess Revenues
Sub-total.....	\$ 464,530,000	\$ 464,530,000					
TOTAL REVENUE BONDS.....	<u>\$ 575,845,000</u>	<u>\$ 575,845,000</u>					
TOTAL ALL BONDS.....	<u>\$1,846,530,000</u>	<u>\$ 1,932,160,000</u>					

- (1) Series BC/BF includes Series BC, Series BD, Series BE and Series BF.
- (2) Subject to redemption at par from a portion of prepayments on all Contracts of Purchase as allocated to Series based on periodically determined ratio of outstanding bonds (including Veterans G.O. Bonds and Revenue Bonds) of Series to all outstanding bonds. Series BC/BF is now subject to optional redemption at par.
- (3) The Series BC/BF Bonds are subject to optional redemption prior to their respective stated maturity dates, in whole on the first day of any month, or in part on any interest payment date.
- (4) Except as described in the next sentence, the Series BG Bonds and Series BH Bonds are subject to optional redemption on and after December 1, 2008, initially at 101% of the principal amount thereof, declining to par on December 1, 2009. The Series BH Bonds maturing on December 1, 2018, December 1, 2024, and December 1, 2032 are currently subject to optional redemption at 101% of the principal amount thereof, declining to redemption at par on or after December 1, 2005. The Series BK Bonds are not subject to optional redemption.
- (5) The BJ-11/12 Serial Bonds maturing on December 1, 2011 through and including December 1, 2016 are subject to optional redemption on December 19, 2010, initially at 101% of the principal amount thereof, declining to par on and after December 19, 2011. The BJ-11/12 Term Bonds maturing on December 1, 2032 are subject to optional redemption on December 19, 2006, initially at 102% of the principal amount thereof, declining to par on and after December 19, 2008.
- (6) Excess Revenues includes principal prepayments.
- (7) Veterans G.O. Bonds that are part of the Spring 2005 Transactions.
- (8) Reflects partial redemption by the expected issuance of the Veterans G.O. Bonds as part of the Spring 2005 Transactions.
- (9) Reflects full or partial redemption by the expected issuance of the Offered Revenue Bonds as part of the Spring 2005 Transactions.



### Additional Investments

In addition to the investments described above under "Contracts of Purchase--Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments," the following investments have been made or will be made with respect to moneys in the 1943 Fund and in the Bond Reserve Account which secures the Revenue Bonds. Additional moneys in various Funds and Accounts in the 1943 Fund have been invested in SMIF. Amounts invested in SMIF may be withdrawn and reinvested at any time.

<u>Bond Series</u>	<u>Account Designation<sup>(1)</sup></u>	<u>Amount (000s)</u>	<u>Investment Provider<sup>(1)</sup></u>	<u>Initial Investment Date</u>	<u>Investment Maturity Date</u>	<u>Interest Rate (%)</u>	<u>Bond Series</u>	<u>Account Designation<sup>(1)</sup></u>	<u>Amount (000s)</u>	<u>Investment Provider<sup>(1)</sup></u>	<u>Initial Investment Date</u>	<u>Investment Maturity Date</u>	<u>Interest Rate (%)</u>
1997/1998	Reserve	\$5,251 <sup>(14)</sup>	Societe Generale	3/26/98	12/1/28	5.75	BJ 7-8	Revenue/ Recycling	variable <sup>(6)</sup>	Bayerische Landesbank Girozentrale	12/1/99	12/1/32 <sup>(6)</sup>	6.06
1997/1998	Reserve	\$6,513 <sup>(12,13)</sup>	U.S. Treasury	5/8/98	5/15/05	6.50	BJ 9-10	Revenue/ Recycling	variable <sup>(8)</sup>	Westdeutsche Landesbank Girozentrale <sup>(7)</sup>	4/27/00	12/1/32 <sup>(8)</sup>	
1999 A/B	Reserve	\$9,817 <sup>(13)</sup>	Westdeutsche Landesbank Girozentrale <sup>(7)</sup>	3/30/99	12/1/28	5.38	BS	Revenue	variable <sup>(8)</sup>	Westdeutsche Landesbank Girozentrale <sup>(7)</sup>	4/27/00	12/1/32 <sup>(8)</sup>	
2000 A/B/C	Reserve	\$2,715 <sup>(13)</sup>	Trinity Plus Funding Company, LLC	4/1/00	12/1/27	6.895	BJ 11/12	Revenue/ Recycling	variable <sup>(9)</sup>	Westdeutsche Landesbank Girozentrale <sup>(7)</sup>	12/19/00	12/1/32 <sup>(9)</sup>	6.46
1997 C	Reserve	\$5,733 <sup>(13)</sup>	Westdeutsche Landesbank Girozentrale <sup>(7)</sup>	1/1/01	12/1/19	5.625	BT/BU	Revenue/ Recycling	variable <sup>(10)</sup>	Westdeutsche Landesbank Girozentrale <sup>(7)</sup>	12/19/00	12/1/26 <sup>(10)</sup>	6.46
2002 A	Reserve	\$3,759 <sup>(13)</sup>	Bayerische Landesbank Girozentrale	3/6/02	12/1/27	5.38	1997 C	Revenue/ Restricted Recoveries	variable <sup>(11)</sup>	Westdeutsche Landesbank Girozentrale <sup>(7)</sup>	1/9/01	12/1/19	5.50
BG/BH/BK /BL	Revenue/ Recycling	variable <sup>(3)</sup>	Societe Generale	12/29/97	12/1/32	5.91	BV/BW	Revenue/ Recycling	variable <sup>(12)</sup>	Bayerische Landesbank Girozentrale	6/20/01	12/1/32 <sup>(12)</sup>	5.50
1997/1998	Revenue/ Restricted Recoveries	variable	Societe Generale	3/26/98	12/1/28	5.91	BX	Revenue/ Recycling	variable <sup>(12)</sup>	Bayerische Landesbank Girozentrale	6/20/01	12/1/32 <sup>(12)</sup>	5.50
BP/BN-1	Revenue/ Recycling	variable <sup>(4)</sup>	Westdeutsche Landesbank Girozentrale <sup>(7)</sup>	5/5/98	12/1/28	5.38							
BQ/BR	Revenue/ Recycling	variable <sup>(5)</sup>	Westdeutsche Landesbank Girozentrale <sup>(7)</sup>	4/28/99	12/1/29	5.37							

Footnotes are on the following page.

- (1) Accounts are established in the resolutions authorizing the issuance of Revenue Bonds. All investments are investment agreements unless otherwise noted.
- (2) At cost. Invested in U.S. Treasury Bonds.
- (3) Maximum permitted amount on deposit under investment agreement at any one time is \$250,000,000.
- (4) Maximum permitted amount on deposit under investment agreement for all (BN-1 and BP) subaccounts is \$50,000,000.
- (5) Maximum permitted amount on deposit under investment agreement for both subaccounts is \$35,000,000.
- (6) Maximum permitted amount on deposit under investment agreement for all (BJ 7/8 and 1991 A) subaccounts is \$25,000,000. Investment maturity date for the recycling subaccounts is December 1, 2009.
- (7) S&P has announced a negative ratings outlook for this bank.
- (8) Maximum permitted amount on deposit under investment agreement for all three (BJ 9/10 and BS) subaccounts is \$20,000,000. Investment maturity date for BJ-9/10 G.O. Bond Series Recycling Subaccount is June 1, 2010.
- (9) Maximum permitted amount on deposit under investment agreement for both subaccounts is \$25,000,000. Investment maturity date for BJ-11/12 G.O. Bond Series Recycling Subaccount is December 1, 2010.
- (10) Maximum permitted amount on deposit under investment agreement for both subaccounts is \$20,000,000. Investment maturity date for BT/BU G.O. Bond Series Recycling Subaccount is December 1, 2010.
- (11) Maximum permitted amount on deposit under investment agreement for both subaccounts is \$97,130,000.
- (12) Maximum permitted amount on deposit under investment agreement for all (BV/BW, 2001 A, BX) subaccounts is \$25,000,000. Investment maturity date for all (BV/BW, 2001 A, BX) recycling subaccounts is December 1, 2011.
- (13) As of December 31, 2004.

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## **APPENDIX D**

### **SUMMARY OF CERTAIN PROVISIONS OF THE MASTER CONTINUING DISCLOSURE UNDERTAKING**

Certain provisions of the Master Continuing Disclosure Undertaking of the Department not previously discussed in this Official Statement are summarized below. This summary does not purport to be complete or definitive and is qualified in its entirety by reference to the full terms of the Master Continuing Disclosure Undertaking.

The Master Continuing Disclosure Undertaking, dated December 29, 1997, was executed and delivered by the Department for the benefit of the Holders and the Beneficial Owners and in order to assist the Underwriters in complying with SEC Rule 15c2-12(b)(5). The Offered Revenue Bonds are Subject Bonds.

#### **Certain Definitions**

Defined terms used in the Master Continuing Disclosure Undertaking and not otherwise defined therein have the meanings set forth in the Resolution.

“Beneficial Owner” means a Beneficial Owner of Subject Bonds, as determined pursuant to the Rule.

“Bonds” means, at any time, all of the Department’s then Outstanding Home Purchase Revenue Bonds, collectively.

“Fiscal Year” means that period established by the Department with respect to which its, as applicable, Audited Financial Statements or Unaudited Financial Statements, as defined in the Master Continuing Disclosure Undertaking, are prepared. As of the date of the Master Continuing Disclosure Undertaking, the Department’s Fiscal Year begins on July 1 and ends on June 30 of the next calendar year.

“Holders” means the registered owners of the Subject Bonds.

“Listed Event” means any of the events listed below under the heading “Reporting of Certain Events”.

“MSRB” means the Municipal Securities Rulemaking Board established pursuant to Section 15B(b)(1) of the Securities Exchange Act of 1934.

“Notice” means written notice, sent for overnight delivery via the United States Postal Service or a private delivery service which provides evidence of delivery.

“Notice Address” means with respect to the Department:

State of California Department of Veterans Affairs 1227 “O” Street Sacramento, CA 95814 Attention: Bond Finance Division.

“NRMSIR” means, at any time, a then-existing nationally recognized municipal securities information repository, as recognized from time to time by the SEC for the purposes referred to in the Rule.

“Official Statement” means the offering document of the Department dated December 10, 1997 with respect to the Department’s Home Purchase Revenue Bonds, 1997 Series A, 1997 Series B, 1997 Series C, and 1998 Series A.

“Rule” means the applicable provisions of Rule 15c2-12 promulgated by the SEC under the Securities Exchange Act of 1934, as amended (17 CFR Part 240, § 240.15c2-12), as in effect on the date of the Master Continuing Disclosure Underwriting including any official interpretations thereof.

“SEC” means the United States Securities and Exchange Commission.

“Securities Counsel” means legal counsel expert in Federal securities laws.

“SID” means, at any time, a then-existing state information depository, if any, as operated or designated as such by or on behalf of the State and recognized by the SEC for the purposes referred to in the Rule.

“Subject Bonds” means those Bonds with respect to which the terms of the Master Continuing Disclosure Undertaking are expressly incorporated into any one of the Department documents authorizing the issuance of such Bonds.

“Underwriters” means any of the original underwriters of any Subject Bonds required to comply with the Rule in connection with the offering of such Subject Bonds.

### **Provision of Annual Financial Information**

The Department will, not later than the first day of the tenth calendar month after the end of each of the Department’s Fiscal Years, commencing with the report for the 1996-1997 Fiscal Year, provide to the Trustee and to each NRMSIR and the SID the Annual Financial Information. The Audited Financial Statements of the Department and of the Bond Reserve Account and Loan Loss Account may be submitted separately from the balance of the Annual Financial Information, and later than the date required for the filing of the Annual Financial Information if not available by that date.

The Master Continuing Disclosure Undertaking requires the Department to provide, in a timely manner, notice of any failure by it to provide Annual Financial Information to each NRMSIR and the SID on or before the date described in the first paragraph under this heading, to the SID, to the Trustee and to either (i) each NRMSIR or (ii) the MSRB.

### **Content of Annual Financial Information**

The Department’s Annual Financial Information shall contain or include by reference the following:

(a) the audited financial statements of the 1943 Fund and of the Bond Reserve Account and Loan Loss Account for the Fiscal Year ended on the previous June 30, prepared in accordance with generally accepted accounting principles established by the Financial Accounting Standards Board, if available, or unaudited financial statements for such Fiscal Year; and

(b) financial information or operating data of the types included in APPENDIX D of the Official Statement entitled “Certain Department Financial Information and Operating Data.”\*\*

If not provided as part of the Annual Financial Information by the date required (as described above under “Provision of Annual Financial Information”), the Department shall provide audited financial statements, when and if available, to the Trustee and to each NRMSIR and the SID.

Any or all of the items listed above may be included by specific reference to other documents, including fiscal statements of debt issues of the Department or related public entities, which have been submitted to each NRMSIR and the SID or the SEC. (If such document is an official statement, it must also be available from the MSRB.) Annual Financial Information may be provided in one document or multiple documents, and at one time or in part from time to time.

### **Reporting of Certain Events**

The Department will give notice to the Trustee and to the SID and to either each NRMSIR or the MSRB of the occurrence of any of the following events with respect to the Subject Bonds, if material:

As of the date of this Official Statement, there is no SID.

- (1) principal and interest payment delinquencies;
- (2) non-payment related defaults;
- (3) modification to rights of Holders;
- (4) Subject Bond calls;
- (5) unscheduled draws on credit enhancements reflecting financial difficulties;
- (6) substitution of credit or liquidity providers, or their failure to perform;
- (7) defeasances;
- (8) rating changes;
- (9) adverse tax opinions or events affecting the tax-exempt status (if applicable) of any Subject Bonds;

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\* Such information or data is substantially similar to that included in APPENDIX C of this Official Statement.

- (10) unscheduled draws on the debt service reserves reflecting financial difficulties; or
- (11) release, substitution or sale of property securing repayment of the Subject Bonds.

### **Additional Information**

Nothing in the Master Continuing Disclosure Undertaking shall be deemed to prevent the Department from disseminating any other information, using the means of dissemination set forth in the Master Continuing Disclosure Undertaking or any other means of communication, or including any other information in any Annual Financial Information or notice of occurrence of a Listed Event, in addition to that which is required by the Master Continuing Disclosure Undertaking. If the Department chooses to include any information in any Annual Financial Information or notice of occurrence of a Listed Event in addition to that which is specifically required by the Master Continuing Disclosure Undertaking, the Department shall have no obligation under the Master Continuing Disclosure Undertaking to update such information or include it in any future Annual Financial Information or notice of occurrence of a Listed Event.

### **Amendment of Master Continuing Disclosure Undertaking**

The Master Continuing Disclosure Undertaking may be amended and any provision of the Master Continuing Disclosure Undertaking may be waived, without the consent of the Holders or Beneficial Owners, except as described in clause 4(ii) below, under the following conditions: (1) such amendment or waiver is made in connection with a change in circumstances that arises from a change in legal (including regulatory) requirements, a change in law (including rules or regulations) or in interpretations thereof, or a change in the identity, nature, or status of the Department or the type of business conducted thereby, (2) the Master Continuing Disclosure Undertaking as so amended or waived would have complied with the requirements of the Rule as of the date of each primary offering of Subject Bonds affected by such amendment or waiver, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances, (3) the Department shall have delivered to the Trustee an opinion of Securities Counsel, addressed to the Department and the Trustee, to the same effect as set forth in clause (2) above, (4) either (i) a party unaffiliated with the Department (such as the Trustee or bond counsel), acceptable to the Trustee and the Department, has determined that the amendment or waiver does not materially impair the interests of the Beneficial Owners, or (ii) the Holders consent to the amendment to or waiver of the Master Continuing Disclosure Undertaking pursuant to the same procedures as are required for amendments to the Resolution with consent of Holders, and (5) the Department shall have delivered copies of such amendment or waiver to the SID, to the Trustee, and to either each NRMSIR or the MSRB.

In addition to the foregoing, the Department may amend the Master Continuing Disclosure Undertaking, and any provision of the Master Continuing Disclosure Undertaking may be waived, if the Trustee shall have received an opinion of Securities Counsel, addressed to the Department and the Trustee, to the effect that the adoption and the terms of such amendment or waiver would not, in and of themselves, cause the undertakings in the Master Continuing Disclosure Undertaking to violate the Rule, taking into account any subsequent change in or official interpretation of the Rule.

## **Benefit; Enforcement**

The provisions of the Master Continuing Disclosure Undertaking shall inure solely to the benefit of the Holders and Beneficial Owners from time to time.

Except as described in this paragraph, the provisions of the Master Continuing Disclosure Undertaking will create no rights in any other person or entity. The obligation of the Department to comply with the provisions of the Master Continuing Disclosure Undertaking shall be enforceable (i) in the case of enforcement of obligations to provide financial statements, financial information, operating data, and notices, by any Beneficial Owner of Outstanding Subject Bonds, or by the Trustee on behalf of the Holders of Outstanding Subject Bonds, or (ii) in the case of challenges to the adequacy of the financial statements, financial information, and operating data so provided, by the Trustee on behalf of the Holders of Outstanding Subject Bonds or by any Beneficial Owner; provided, however, that a Beneficial Owner may not take any enforcement action pursuant to clause (ii) without the consent of the Holders of not less than 20% in aggregate principal amount of the Subject Bonds at the time Outstanding.

The right to enforce the provisions of the Master Continuing Disclosure Undertaking shall be limited to a right, by action in mandamus or for specific performance, to compel performance of the Department's obligations under the Master Continuing Disclosure Undertaking. Any failure by the Department to perform in accordance with the Master Continuing Disclosure Undertaking will not constitute a default or an Event of Default under the Resolution, and the rights and remedies provided by the Resolution upon the occurrence of a default or an Event of Default will not apply to any such failure.

## **Termination of Reporting Obligation**

The Department's obligations under the Master Continuing Disclosure Undertaking with respect to the Subject Bonds shall terminate upon the legal defeasance under the Resolution, prior redemption, or payment in full of all of the Subject Bonds. The Department shall give notice of any such termination to the SID and to either each NRMSIR or the MSRB.

The Master Continuing Disclosure Undertaking, or any provision thereof, will be null and void to the extent set forth in the opinion of Securities Counsel described in clause (1) in the event that the Department (1) delivers to the Trustee an opinion of Securities Counsel, addressed to the Department and the Trustee, to the effect that those portions of the Rule which require the provisions of the Master Continuing Disclosure Undertaking, or any of such provisions, do not or no longer apply to the Subject Bonds, whether because such portions of the Rule are invalid, have been repealed, or otherwise, as will be specified in such opinion, and (2) delivers notice to such effect to the Trustee, to the SID and to either each NRMSIR or the MSRB.

## **Governing Law**

The Master Continuing Disclosure Undertaking will be construed and interpreted in accordance with the laws of the State, and any suits and actions arising out of the Master Continuing Disclosure Undertaking will be instituted in a court of competent jurisdiction in the State, provided that, to the extent the Master Continuing Disclosure Undertaking addresses matters of Federal securities laws, including the Rule, the Master Continuing Disclosure



Undertaking will be construed in accordance with such Federal securities laws and official interpretations thereof.

## **APPENDIX E**

### **PROPOSED FORM OF OPINION OF BOND COUNSEL TO THE DEPARTMENT TO BE DELIVERED IN CONNECTION WITH THE ISSUANCE OF THE OFFERED REVENUE BONDS**

[CLOSING DATE]

Department of Veterans Affairs  
of the State of California  
1227 "O" Street, Room 200A  
Sacramento, California 95814

Ladies and Gentlemen:

We have acted as bond counsel to the Department of Veterans Affairs of the State of California (the "Department") and in such capacity we have examined upon request copies of proceedings taken by the Department in connection with the issuance of the Department's Home Purchase Revenue Bonds, Series 2005 A (the "Bonds"), in the aggregate principal amount of \$42,600,000, and the sale of the Bonds to the initial purchasers thereof. The Bonds are issued pursuant to (1) the Veterans' Revenue Debenture Act of 1970, as amended, constituting Chapter 7 of Division 4 of the Military and Veterans Code of the State of California (the "Veterans Act"), (2) the Resolution of Issuance for Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, adopted March 19, 1980 (the "Resolution of Issuance"), (3) the Eighth Supplemental Resolution Providing for Amendments and Supplements to the Resolution No. RB-1, adopted November 24, 1997 (the "Eighth Supplemental Resolution"), (4) the Tenth Supplemental Resolution Providing for Amendments and Supplements to the Resolution No. RB-1, adopted February 24, 1999 (the "Tenth Supplemental Resolution"), and (5) the Sixteenth Supplemental Resolution Providing for the Issuance of an Amount Not to Exceed \$307,490,000 Principal Amount of Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, adopted March 28, 2005 (the "Sixteenth Supplemental Resolution"). The Resolution of Issuance, the Eighth Supplemental Resolution, the Tenth Supplemental Resolution, and the Sixteenth Supplemental Resolution are collectively referred to herein as the "Resolution."

The Bonds are dated, mature on the dates in the principal amounts, bear interest, if any, and are payable as provided in the Resolution. The Bonds are subject to mandatory and optional tender and redemption prior to maturity in whole or in part as set forth in the Resolution.

The State of California (the "State") intends to issue its Veterans General Obligation Bonds, Series CA and Series CB (the "Series CA and CB Bonds") in April 2005. The Bonds and the Series CA and CB Bonds are treated as a single issue for certain Federal tax purposes under the Internal Revenue Code of 1986, as amended (the "Code"). Applicable Federal tax law establishes certain requirements that must be met subsequent to the issuance of the Bonds and the Series CA and CB Bonds in order that interest on the Bonds not be included in gross income

for Federal income tax purposes under the Code. The Department has adopted documents with respect to its program (the "Program Documents") that establish procedures under which, if followed, such requirements can be met. The Department has covenanted in the Resolution to at all times perform all acts and things permitted by law and necessary and desirable in order to assure that interest paid on the Bonds shall not be included in gross income for Federal income tax purposes under the Code. In rendering this opinion, we have relied upon such covenant and have assumed compliance by the Department with and enforcement by the Department of the provisions of the Resolution and the Program Documents.

In connection with the issuance of the Bonds, we have examined (a) a copy of the Resolution, and (b) such other opinions, documents, certificates and letters as we deem relevant and necessary in rendering this opinion.

From such examination, we are of the opinion that:

1. Pursuant to the Veterans Act, the Department is empowered to issue the Bonds for the purposes specified in the Resolution, and to pledge the revenues and amounts in the funds and accounts established by the Resolution.
2. The Bonds have been validly authorized, executed and issued in accordance with the laws of the State of California and represent the legally valid and binding special obligations of the Department, enforceable in accordance with their terms and secured in the manner and to the extent set forth in the Resolution, and are entitled to the benefit, protection and security of the provisions, covenants and agreements contained therein.
3. The Resolution has been duly and lawfully adopted, is a valid resolution of the Department and is binding upon the Department in accordance with its terms.
4. The Resolution creates a valid pledge to secure, on an equal and pro rata basis, the payment, subject to lawful appropriation, of the principal of and interest on the Bonds of (i) an undivided interest in the assets of the Veterans' Farm and Home Building Fund of 1943 (the "1943 Fund"), except proceeds of State veterans general obligation bonds and amounts in the Rebate Account established under the Resolution, which undivided interest is secondary and subordinate to any interest or right of the people of the State of California and the holders of general obligation bonds in the 1943 Fund, created in accordance with any general obligation veterans bond act, (ii) any amounts held in the Bond Reserve Account established pursuant to the Resolution, and (iii) any amounts held in the Loan Loss Account established pursuant to the Resolution, which pledge is subject only to the provisions of the Resolution permitting the application of such assets and amounts for or to the purposes and on the terms and conditions set forth in the Resolution.
5. Under existing statutes and court decisions, and assuming compliance by the Department with certain tax covenants described herein, (i) interest on the Bonds is excluded from gross income for Federal income tax purposes pursuant to Section 103 of the Code, and (ii) interest on the Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest,

*however*, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations. No opinion as to exclusion from gross income of interest on any of the Bonds is expressed subsequent to any date on which action is taken pursuant to the Resolution for which action the Resolution requires a legal opinion to the effect that taking such action will not adversely affect such exclusion, should the undersigned not deliver an opinion as of such date to such effect.

6. Under existing law, interest on the Bonds is exempt from State personal income taxation.

With respect to the matters referenced in paragraphs 5 and 6 above, we express no opinion regarding any other Federal or state tax consequences with respect to the Bonds. We render our opinion under existing statutes and court decisions as of the issue date of the Bonds, and assume no obligation to update our opinion after the issue date to reflect any future action, fact or circumstance, or change in law or interpretation, or otherwise. We express no opinion on the effect of any action taken after the date of issuance of the Bonds, or not taken, in reliance upon an opinion of other counsel on the exclusion from gross income for Federal income tax purposes of interest on the Bonds, or under state and local tax law. We undertake no responsibility for the accuracy, completeness or fairness of any official statement or other offering materials relating to the Bonds and express herein no opinion relating thereto.

In rendering this opinion, we are advising you that the enforceability of the Bonds and the Resolution may be limited by bankruptcy, moratorium, insolvency, or other laws affecting creditors' rights or remedies and is subject to general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

Very truly yours,

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## **APPENDIX F**

### **PROPOSED FORM OF OPINION OF THE ATTORNEY GENERAL TO BE DELIVERED IN CONNECTION WITH THE ISSUANCE OF THE OFFERED REVENUE BONDS**

[Closing Date], 2005

Department of Veterans Affairs  
of the State of California  
1227 "O" Street, Room 200A  
Sacramento, CA 95814

Ladies and Gentlemen:

We have acted as the Attorney General of the State of California in connection with the issuance by the Department of Veterans Affairs of the State of California (the "Department") of its Home Purchase Revenue Bonds, 2005 Series A (the "Bonds"), in the aggregate principal amount of \$42,600,000. The Bonds are issued pursuant to (1) the Veterans' Revenue Debenture Act of 1970, as amended, constituting Chapter 7 of Division 4 of the Military and Veterans Code of the State of California (the "Veterans Revenue Debenture Act"), (2) the Resolution of Issuance for Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, adopted March 19, 1980 (the "Resolution of Issuance"), (3) the Eighth Supplemental Resolution Providing for Amendments and Supplements to the Resolution No. RB-1, adopted November 24, 1997 (the "Eighth Supplemental Resolution"), (4) the Tenth Supplemental Resolution Providing for Amendments and Supplements to the Resolution No. RB-1, adopted February 24, 1999 (the "Tenth Supplemental Resolution"), and (5) the Sixteenth Supplemental Resolution Providing for the Issuance of an Amount Not to Exceed \$307,490,000 Principal Amount of Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, adopted March 28, 2005 (the "Sixteenth Supplemental Resolution"). The Resolution of Issuance, the Eighth Supplemental Resolution, the Tenth Supplemental Resolution, and the Sixteenth Supplemental Resolution are collectively referred to herein as the "Resolution."

In such connection, we have reviewed the Resolution, certifications of the Department, the Treasurer of the State of California and others, opinions of counsel to the Department, and such other documents, opinions and matters to the extent we deemed necessary to render the opinions set forth herein. We have assumed, without undertaking to verify, the genuineness of all documents, certificates and opinions presented to us (whether as originals or as copies) and of the signatures thereon, the accuracy of the factual matters represented, warranted or certified in the documents and certificates, the correctness of the legal conclusions contained in the opinions, and the due and legal execution of the documents and certificates by, and validity thereof against, any parties other than the Department.

The opinions expressed herein are based on an analysis of existing laws, regulations, rulings and court decisions and cover certain matters not directly addressed by such authorities. Such opinions may be affected by actions taken or omitted or events occurring after the date

hereof. We have not undertaken to determine, or to inform any person, whether any such actions are taken or omitted or events do occur or any other matters come to our attention after the date hereof. We disclaim any obligation to update this opinion. Furthermore, we have assumed compliance with all covenants and agreements contained in the Resolution.

In addition, we call attention to the fact that the rights and obligations under the Bonds, the Resolution and their enforceability may be subject to bankruptcy, insolvency, reorganization, arrangement, fraudulent conveyance, moratorium and other laws relating to or affecting creditors' rights, to the application of equitable principles, to the exercise of judicial discretion in appropriate cases and to the limitations on legal remedies against the State of California and its departments. We express no opinion with respect to any indemnification, contribution, penalty, choice of law, choice of forum or waiver provisions contained in the foregoing documents nor do we express any opinion with respect to the state or quality of title to or interest in any of the real or personal property described in or subject to the lien of the Resolution or the accuracy or sufficiency of the description of any such property contained therein of, or the remedies available to enforce liens on, any such property. We express no opinion as to whether interest on the Bonds is excluded or exempt from gross income for federal income tax purposes or is exempt from State of California personal income taxes, or as to any other tax consequence relating to the ownership or disposition of, or the accrual or receipt of interest on, the Bonds. Finally, we undertake no responsibility for the accuracy, completeness or fairness of the Official Statement dated April 12, 2005, pertaining to the Bonds, or other offering material relating to the Bonds and express no opinion with respect thereto.

Based on and subject to the foregoing, and in reliance thereon, as of the date hereof, we are of the opinion that:

1. The Bonds have been validly authorized, executed and issued in accordance with the laws of the State of California and constitute the valid and binding special obligations of the Department payable solely from and secured by the Pledged Property (as defined in the Resolution) under the Resolution. The Bonds are not a lien, charge or liability against the State of California, or against the Department, or against the property or funds of either, except only as to the Department and its property or funds as set forth in the Resolution. The owners of the Bonds cannot compel the exercise of the taxing power of the State of California or the forfeiture of its property to pay the Bonds or the interest thereon.

2. The Resolution has been duly and lawfully adopted, is a valid resolution of the Department and is binding upon the Department in accordance with the terms of the Resolution.

3. The Resolution creates a valid pledge to secure, on an equal and pro rata basis, the payment, subject to lawful appropriation, of the principal of and interest on the Bonds of (1) an undivided interest in the assets of the Veterans' Farm and Home Building Fund of 1943 (the "1943 Fund"), except proceeds of Veterans General Obligation Bonds (as defined in the Resolution) and amounts in the Rebate Account established under the Resolution, which undivided interest is secondary and subordinate to any interest or right of the people of the State of California and the holders of Veterans General Obligation Bonds in the 1943 Fund under any general obligation veterans bond act; and (2) any amounts held in the Bond Reserve Account and

the Loan Loss Account established pursuant to the Resolution within the Veterans Debenture Fund (as defined in the Resolution); which pledge is subject only to the provisions of the Resolution permitting the application of such assets and amounts for or to the purposes and on the terms and conditions set forth in the Resolution.

Sincerely,

Deputy Attorney General

For: BILL LOCKYER  
Attorney General



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## APPENDIX G

### CERTAIN FEDERAL TAX CODE REQUIREMENTS

The Federal Tax Code restricts the issuance of Federally tax-exempt bonds to finance mortgage loans for single family housing or to refund such bonds.

Those Federal Tax Code restrictions are not the same for all such tax-exempt bonds. There are three types of such tax-exempt bonds: (i) qualified mortgage bonds, which provide Qualified Mortgage Bond Proceeds, (ii) qualified veterans' mortgage bonds, which provide Qualified Veterans' Mortgage Bond Proceeds, and (iii) pre-Ullman bonds, which provide Unrestricted Moneys. Revenue Bonds may be either qualified mortgage bonds or pre-Ullman Bonds. ("Pre-Ullman bonds" are bonds issued before 1981, or bonds issued to refund such bonds.) Veterans G.O. Bonds may be either qualified veterans' mortgage bonds or pre-Ullman bonds. The principal Federal Tax Code restrictions relate to: (i) the use of proceeds of the bond issue, (ii) the yield on the financed mortgage loans and from certain non-mortgage investments related to the issue, (iii) for qualified mortgage bonds and qualified veterans' mortgage bonds, loan eligibility requirements, (iv) for qualified mortgage bonds, the availability of proceeds of the issue for financing housing located in "targeted areas," and (v) certain matters relating to the issue itself.

See "TAX MATTERS" for information regarding the requirements applicable to the Offered Revenue Bonds.

Failure to comply with the applicable provisions of the Federal Tax Code may result in interest on the applicable issue of bonds being included in gross income for federal income tax purposes retroactive to the date of issuance thereof.

#### ***Loan Eligibility Requirements Imposed by the Federal Tax Code on Qualified Mortgage Bond Proceeds and Qualified Veterans' Mortgage Bond Proceeds***

##### ***Qualified Mortgage Bond Proceeds***

The Federal Tax Code contains the following loan eligibility requirements with respect to Qualified Mortgage Bond Proceeds, except that the requirements described under "First-Time Homebuyer Requirement," "Purchase Price Limitation," and "Other Requirements Imposed by the Federal Tax Code – Recapture Provision Applicable to Qualified Mortgage Bonds" do not apply to home improvement loans, and the requirements described under "Qualified Home Improvement Loans" do not apply to loans for the acquisition of single family homes. None of those requirements applies to pre-Ullman bonds or qualified veterans' mortgage bonds.

Residence Requirement. The Federal Tax Code requires that each of the premises financed with the lendable proceeds of qualified mortgage bonds be a one-to-four-family residence, one unit of which can reasonably be expected to become the principal residence of the veteran within a reasonable time after the financing is provided. Certain documents adopted by the Department establish procedures to be followed in connection with Contracts of Purchase which finance the acquisition of single family homes in order to assure that interest paid on the qualified mortgage bonds not be included in gross income for Federal income tax purposes under

the Federal Tax Code (the "Single Family Program Documents"). Certain documents adopted by the Department establish procedures to be followed in connection with Contracts of Purchase to finance home improvement loans intended to assure that interest paid on the qualified mortgage bonds is not included in gross income for Federal income tax purposes under the Federal Tax Code (the "Home Improvement Program Documents," together with the Single Family Program Documents, the "Program Documents"). In connection with the financing of a Contract of Purchase, the Program Documents require that each veteran submit an affidavit stating such person's intention to occupy the premises as his principal residence within 60 days after closing of the Contract of Purchase.

First-Time Homebuyer Requirement. The Federal Tax Code requires that, subject to certain exceptions, the lendable proceeds of qualified mortgage bonds be used to provide financing to borrowers who have not had a present ownership interest in their principal residence during the three-year period prior to execution of the mortgage loan. All financing with respect to targeted area residences and residences on land possessed under certain contract for deed agreements is treated as satisfying the first time homebuyer requirement. Veterans subject to this requirement are required to provide federal income tax returns for the previous three years or other appropriate certifications to allow verification that no deductions or other entries have been made that would indicate any such ownership interest.

New Mortgage Requirement. The Federal Tax Code requires that, with certain limited exceptions, the lendable proceeds of qualified mortgage bonds finance new mortgage loans only and that no proceeds may be used to acquire or replace an existing mortgage loan, which would include the refinancing of a pre-existing mortgage loan. The Program Documents state that the Department will verify compliance with the new mortgage requirement by requiring each veteran to certify prior to financing, subject to such exceptions, that no refinancing of a prior mortgage loan is being effected.

Purchase Price Limitation. The Federal Tax Code requires that the purchase price of the residence financed with the lendable proceeds of qualified mortgage bonds may not exceed 90% of the average area purchase price applicable to such residence or 110% of the applicable average area purchase price in the case of residences located in targeted areas. The Program Documents state that the Department will verify compliance with the purchase price limitations by requiring each veteran and seller of a residence to make certifications regarding the purchase price of such residence.

Income Limitation. The Federal Tax Code requires that all mortgage loans made from the lendable proceeds of qualified mortgage bonds be made only to borrowers whose family income does not exceed 115% (for mortgage loans made to families with fewer than three members, 100%) of the applicable median family income. An exception is provided for mortgage loans financed with the lendable proceeds of qualified mortgage bonds made with respect to targeted area residences that permits two-thirds in aggregate amount of such mortgage loans to be made with respect to borrowers whose family income does not exceed 140% (for mortgage loans made to families with fewer than three members, 120%) of the applicable median family income and one-third in aggregate amount of such loans to be made without regard to any income limitation.

Federal tax law permits higher income limits for persons financing homes located in certain "high housing cost areas." A high housing cost area is a statistical area for which the ratios of the area's average purchase price for existing and new single family houses to the area's median income exceed 120% of the same ratios determined on a national basis. These ratios are determined separately with respect to new and existing single family residences. An area is a high housing cost area only if the ratios for both new and existing houses meet the 120% test. In high housing cost areas, the veteran income limits are increased above 115% (or 100%, as applicable) by one percent for each percentage point (1%) by which the new or existing housing price ratio, whichever is smaller, exceeds 120%. However, the new limit cannot exceed 140% (or 120%, as applicable) of the income limits otherwise applicable. Certain areas of the State may qualify as high housing cost areas.

Family income includes income of all individuals executing both the note and mortgage and occupying the dwelling as their principal residence.

Requirements as to Assumptions. The Federal Tax Code provides that a mortgage loan may be assumed only if each of the then applicable residence requirement, first-time-homebuyer requirement, purchase price limitation, and income limitation is met with respect to such assumption. The Contracts of Purchase contain a "due on sale" clause, and the Program Documents state that the assumption of a Contract of Purchase should not be permitted unless these requirements have been met and the appropriate certifications have been obtained.

Qualified Home Improvement Loans. The Federal Tax Code requires that a home improvement loan financed with the lendable proceeds of qualified mortgage bonds not exceed \$15,000, be made only with respect to an owner-occupied residence, and finance alterations, repairs, and improvements on or in connection with an existing one-to-four-family residence by the owner thereof, but only if such alterations, repairs and improvements substantially protect or improve the basic livability or energy efficiency of the property.

General. Qualified mortgage bonds treated under the Federal Tax Code as one bond issue for federal tax purposes ("qualified mortgage issue") are deemed to meet the loan eligibility requirements of the Federal Tax Code if (i) the issuer in good faith attempted to meet all the loan eligibility requirements before the mortgage loans were executed, (ii) any failure to comply with the loan eligibility requirements is corrected within a reasonable period after such failure is first discovered, and (iii) 95% or more of the proceeds of the issue used to make mortgage loans was used to finance residences that met all such requirements at the time the mortgage loans were executed. In determining whether 95% or more of the proceeds has been so used, the Federal Tax Code permits the Department to rely on an affidavit of the veteran and of the seller as to the purchase price of a residence and an affidavit of the veteran and an examination of copies of the veteran's Federal income tax returns for the last three years preceding the date the Contract of Purchase is or was executed even though the relevant information in such affidavits and income tax returns should ultimately prove to be untrue, unless the Department knows or has reason to believe that such information is false.

### *Qualified Veterans' Mortgage Bond Proceeds*

The Federal Tax Code requires that each mortgagor to whom financing is provided under a qualified veterans' mortgage bond issue have served on active duty at some time before January 1, 1977 and apply for financing before the later of January 31, 1985 or the date which is 30 years after the last date on which the veteran left active service. The Department has established and has covenanted to comply with such requirements.

Generally, only the loan eligibility requirements stated above under "Qualified Mortgage Bond Proceeds – Residence Requirement," "– New Mortgage Requirement" and "– Qualified Home Improvement Loans" (*except* the \$15,000 maximum loan amount) apply to Qualified Veterans' Mortgage Bond Proceeds.

### ***Other Requirements Imposed by the Federal Tax Code***

General. The Federal Tax Code provides that gross income for federal income tax purposes does not include interest on a mortgage revenue bond if it is a qualified mortgage bond or a qualified veterans' mortgage bond. A qualified mortgage bond is a part of an issue of a state or political subdivision all the proceeds of which (net of amounts applied to any costs of issuance thereof and to fund a reasonably required reserve) are used to finance (or to refund bonds all of such net proceeds of which were used to finance) owner-occupied residences and that meets certain (i) general requirements, (ii) arbitrage restrictions on the use and investment of proceeds of the issue, and (iii) loan eligibility requirements set forth in the Federal Tax Code and as more fully described above under "Loan Eligibility Requirements Imposed by the Federal Tax Code." A qualified veterans' mortgage bond is part of an issue 95 percent or more of the net proceeds of which are used to provide residences to veterans and that meets certain (i) general requirements, (ii) arbitrage restrictions on the use and investment of proceeds of the issue, and (iii) loan eligibility requirements set forth in the Federal Tax Code and as more fully described above under "Loan Eligibility Requirements Imposed by the Federal Tax Code."

Volume Limitation, Targeted Area and Required Reports. The first general requirement of the Federal Tax Code, applicable to qualified mortgage bonds, is that the aggregate amount of private activity bonds (exclusive of qualified veterans' mortgage bonds) that may be issued by the Department in any calendar year (or previous years' carried forward amount) must not exceed the portion of the private activity bond volume limit for the State for such calendar year that is allocated by the State to the Department. With respect to qualified veterans' mortgage bonds, a separate limit is based on statutory formulae. The second general requirement of the Federal Tax Code applicable to qualified mortgage bonds is that at least 20% of the lendable proceeds of an issue of bonds which are not refunding bonds (if such set-aside was satisfied with respect to the bonds being refunded) must be made available (and applied with reasonable diligence) for owner-financing of residences in targeted areas (as defined by the Federal Tax Code) for at least one year after the date on which such funds are first available for such owner-financing (the "targeted area requirement"). The third general requirement of the Federal Tax Code requires the issuer of qualified mortgage bonds and qualified veterans' mortgage bonds to file with the Internal Revenue Service reports on the issuance of its qualified mortgage bonds or qualified veterans mortgage bonds following such issuance, as well as an annual qualified mortgage loan information report.

Yield Limitations and Rebate. The Federal Tax Code requires that the effective interest rate on mortgage loans financed with the lendable proceeds of qualified mortgage bonds and qualified veterans' mortgage bonds may not exceed the yield on the issue by more than 1.125% (1.50% for pre-Ullman bonds), and that certain investment earnings on non-mortgage investments, calculated based upon the extent such investment earnings exceed the amount that would have been earned on such investments if the investments were invested at a yield equal to the yield on the issue, be rebated to the United States or to veterans. These requirements apply to both Revenue Bonds and Veterans G.O. Bonds, except that for Veterans G.O. Bonds, rebate, absent an election to pay to the United States, is to veterans. The Department has established procedures to determine the amount of excess earnings, if any, that must be rebated to the United States or to veterans. See "SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS – The 1943 Fund" and "THE PROGRAM – Contracts of Purchase" for discussions of provisions of the Veterans Code which affect the Department's ability to establish and to change interest rates on Contracts of Purchase.

Recapture Provision Applicable to Qualified Mortgage Bonds. For certain mortgage loans made after December 31, 1990 from the lendable proceeds of qualified mortgage bonds issued after August 15, 1986 (not including the Offered Revenue Bonds), and for assumptions of such mortgage loans, the Federal Tax Code requires a payment to the United States from certain borrowers upon sale or other disposition of their homes (the "Recapture Provision"). The Recapture Provision requires that an amount determined to be the subsidy provided by a qualified mortgage bond financing to a borrower be paid to the United States on disposition of the residence (but not in excess of 50% of the gain realized by the borrower). The recapture amount would (i) increase over the period of ownership, with full recapture occurring if the residence were sold between four and five full years after the closing of the mortgage loan and (ii) decline ratably to zero with respect to sales occurring between five and nine full years after the closing of the mortgage loan. An exception excludes from recapture part or all of the subsidy in the case of certain assisted individuals whose incomes are less than prescribed amounts at the time of the disposition. The Federal Tax Code requires an issuer to inform borrowers of certain information with respect to the Recapture Provision. The Program Documents include a form of notice and establish procedures to send such notice.

Required Redemptions. For qualified mortgage bonds issued after 1988, the Federal Tax Code permits repayments (including prepayments) of principal of mortgage loans financed with the proceeds of an issue of such bonds to be used to make additional mortgage loans for only 10 years from the date of issuance of the bonds (or the date of issuance of the original bonds in the case of refundings), after which date such amounts must be used to redeem bonds, except for a \$250,000 *de minimis* amount. As a result, the Department is required by the Federal Tax Code to redeem Revenue Bonds which are qualified mortgage bonds from repayments (including prepayments) of principal of certain Contracts of Purchase not later than the close of the semi-annual period after the payment is received.

Compliance. The Federal Tax Code states that an issuer will be treated as meeting the targeted area requirement, the arbitrage restrictions on mortgage loans, and the recapture information requirements if it in good faith attempted to meet all such requirements and any failure to meet such requirements was due to inadvertent error after taking all reasonable steps to comply with such requirements.

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